

Polish FSA comments on the „Countercyclical capital buffer proposal”

Experience of several European countries in the past two decades (for example Ireland, Spain, Portugal or Baltic states) shows that the strength and speed of the economic factors related to changing macroeconomic environment, in these cases the monetary convergence, requires regulatory response that is at least as rapid, and preferably preemptive.

The proposal clearly recognises that credit booms have local character and require local response. This sets the proper base for further considerations that can lead to improving supervisory response towards excessive lending. The details of the proposal bring, however, some concerns about the effectiveness of the envisaged mechanism.

To understand how such a countercyclical buffer would operate it has to be placed within the broader framework being currently developed by BCBS (“Strengthening the resilience of the banking sector”).

According to the current CRD provisions (Basel II), under Pillar I credit institutions need to cover with own funds roughly 8% of the total of their risk weighted assets. The limit of 8% is the minimum that can be increased by local authorities either by a supervisory recommendation or by regulatory decision (Recital (15) of CRD). The freedom to exercise supervisory policy by increasing the capital requirements in response to excessive lending is a vital element of measures that can be taken by national authorities to counter a credit boom endangering the local economy.

The new framework does not determine how the established capital adequacy ratio benchmark of 8% shall be treated in the future. The proposal calls for eliminating Tier 3 as well as the rule that Tier 1 covers at least half of the own funds. Instead, three new limits are considered. Namely, a limit on Core Tier 1 (common equity), a limit on Tier 1 (common equity and hybrid capital) and a limit on Total Capital (presumably Tier 1 and Tier 2).

The current minimum levels that follow from the CRD II provisions are 2% for the Core Tier 1, 4% for Tier 1 and 8% for Total Capital. According to BCBS the new values of these minimum levels shall be set by calibration following an impact assessment.

The crucial issue is that these new requirements are also proposed as a part of the CRD IV package being prepared by the European Commission under an assumption that all these limits shall be increased¹. It is not clear how this assumption can be reconciled with the calibrating process envisaged by BCBS, as it is conceivable that increasing the quality of capital and elimination of Tier 3 may result in keeping the 4% limit for Tier 1 and lowering the total capital requirement.

¹ “73. In revising the definition of capital, the Commission services intend to introduce explicit, higher minimum requirements for the minimum levels of the ratios of Core Tier 1, Tier 1 and total capital (net of deductions) to risk weighted assets.” (page 24, Consultation regarding further possible changes to the Capital Requirements Directive, 26 Feb. 2010)

In Basel III nomenclature the minimum level for Tier 1 capital is called the minimum capital requirement (MCR). On top of this requirement (currently – 4%) a fixed capital conservation buffer shall be applied. According to the proposal:

A buffer range is established above the regulatory minimum Tier 1 capital requirement and capital distribution constraints will be imposed on the bank when capital levels fall within this range. The constraints imposed only relate to distributions, not the fundamental operations of the bank.

The Basel Committee does not wish to impose constraints for entering the range that would be so restrictive as to result in the range being viewed as establishing a new minimum capital requirement.

Therefore, the only effect of the conservation buffer is retention of the prospective profits of the bank. Moreover, the percentage of the profit that needs to be retained shall depend on the size of the gap between the Tier 1 capital of the bank and the minimum capital requirement enlarged by the conservation buffer. The percentages form a table that determines how much profit has to be retained depending on the bank's level of Tier 1 capital. The exact percentages of retained profits as well as the size of the conservation buffer (given as a percentage of risk weighted assets) shall be also calibrated.

The countercyclical buffer that is designed as a supervisory tool to curb excessive credit growth is simply an add-on increasing the predetermined size of the conservation buffer. Its working is described in the proposal as follows:

For example, assume for purely illustrative purposes that the minimum Tier 1 requirement for all banks is 4% of risk weighted assets. Also assume that the capital conservation buffer is set at 2% of risk weighted assets. Under this scenario a bank with a Tier 1 ratio of 6.5% would not be subject to any restrictions on distributions of capital as restrictions are only imposed in the range of 4% – 6%.

Now assume that this bank becomes subject to a countercyclical capital buffer add-on of 2%. The consequence of this is that the range in which restrictions on distributions are imposed becomes 4% – 8%. Now the bank with a Tier 1 capital ratio of 6.5% is in the third quartile of this range and so, using the numbers in the table above, would be required to conserve 60% of earnings.

In short, the countercyclical buffer is set by a local supervisor as an add-on to the predetermined capital conservation buffer sitting on top of the minimum capital requirement for Tier 1. The banks, however, will be obliged to keep the minimum capital requirement for Tier 1 and only retain some portion of their earnings if Tier 1 capital does not cover the minimum requirement enlarged by both these buffers.

In our opinion the effectiveness of such mechanism in dealing with credit bubbles feeding on local economic conditions is questionable for the following reasons:

1. Imposing the countercyclical buffer does not oblige the bank to increase its capital (the buffer has only a potential effect to retain some portion of bank's prospective profits).
2. Due to the abundance of channels that may be used to leak the prospective profits out of the bank, the supervisory decision to retain the profits is hard to execute if it is not coupled with an obligation to increase capital.
3. From the moment of imposing the buffer banks are given 12 months before restrictions on the distribution of profits apply. Therefore, on average, 18 months shall pass before the profits can be retained. Taking into consideration the initial period of collecting the data

indicating that the credit-to-GDP ratio is significantly above its long term trend to justify the imposition of the buffer, gives about two years before the excessive lending can be reflected in material supervisory measures (that is, increasing the capital strength of the credit institutions).

4. The prescribed mechanics of the buffer calibration for fast-changing economies might prove technically difficult, and relevance of its results questionable. Indeed, since the long term trend of credit-to-GDP ratio for emerging markets is based on scarce initial data, the trend may be already so steep that it is unsustainable in the future and needs to be corrected.
5. Finally, the general idea behind the mechanism is that excessive lending is a characteristic of a given country taken as a whole, and the same capital adequacy requirement is applied to ALL bank loans in the country, regardless of their character or type of the borrower. This might be seen as a significant drawback as differences in credit cycles between economic sectors can be more pronounced than those between countries. The property sector in the past several years might serve as an example – while restraining property-related lending would certainly have been prudent, the same could not be said about lending to all other sectors of the economy. As a matter of fact, excessive lending to one sector, if not dampened by corrective measures, often results in lending being “crowded in” into that particular sector, depleting capital availability elsewhere in the economy.

Having the above in mind, it must be stressed, that the corrective measures taken by BCBS aimed at strengthening the capital base in the banking sector should be recognised as the proper way forward to address the shortcomings of the overreliance on a Pillar 2 approach.

Since the proposal gives a slight impression that the countercyclical buffer could be incorporated into the Pillar 1 approach, it may be essential for the establishment of the capital anchor that limits the dangerous drifts that we have witnessed recently.