PricewaterhouseCoopers LLP
Hay's Galleria
1 Hay's Lane
London SE1 2RD
Telephone +44 (0) 20 7583 5000
Facsimile +44 (0) 20 7804 1001
pwc.com

Secretariat: Basel Committee on Banking Supervision (BCBS)
Bank for International Settlements
CH-4002 Basel
Switzerland
Via email to: baselcommittee@bis.org

10 September 2010

Dear Sirs

Countercyclical capital buffer proposal

PricewaterhouseCoopers welcomes the opportunity to provide comments on the Basel Committee on Banking Supervision (BCBS) consultative document of July 2010 entitled 'Countercyclical Capital Buffer Proposal'.

We support the purpose of this proposal to address one of the core objectives set out in the December 2009 consultation paper 'Strengthening the resilience of the banking sector': namely, to achieve the broader macro-prudential goal of protecting the banking sector against the effects of excessive credit growth. We also support the July 2010 proposal's aims to inhibit excess build-up of credit and to limit the impact on lending capacity after a stress.

While we support these objectives we have a number of concerns about the current proposal and make some recommendations for the Committee to consider. Our principal areas of concern include:

- The double-counting that results from an incremental "buffer-to-buffer" approach;
- The danger that a mechanistic approach may move decision-making away from banks and create moral hazard; and
- The operational difficulties in assigning exposures to countries, calibrating the buffer, collating the necessary data, and the implications for capital planning.

We also identify a number of issues with the proposed methodology. Overall we believe that the proposed approach is too complex and somewhat mechanistic and may well not prevent excessive credit growth. In our view a simpler and more flexible approach that uses existing supervisory processes would be a more effective way to deal with credit bubbles (which should be relatively rare) and more focussed on the institutions where such credit concentrations are most prevalent.

Our main recommendations are to:

- Encourage the effective management of risk and capital over the economic cycle;
- Use firm-specific stress tests with a macro-prudential overlay;
- Evaluate the interaction of this proposal with other proposals; and
- Use other targeted macro-prudential tools.

We would be pleased to discuss our comments further with you should you wish. In the first instance please contact me on +44 (0) 20 7804 2304 or Richard Barfield on +44 (0) 20 7804 6658.

Yours faithfully

J L Scott

Jeremy Scott, Global Financial Services Leader

1 Our recommendations

Procyclicality cannot be eliminated from banks' capital requirements, as this is neither possible nor desirable under a risk-sensitive capital regime. Each bank is likely to take a more prudent line when markets are vulnerable, and even with efforts to bring in more countercyclical measures we expect procyclical effects to remain. There is no evidence that the measured proposed would do anything to increase lending as the economy goes through a downturn and lenders become naturally more risk averse.

Our key recommendation is that there should be a greater effort to directly improve the management of risk and capital over the economic cycle at a bank level. Banks should understand the threats of procyclicality in their management of risk and capital. This would be more suitably addressed with micro-prudential tools, such as implementing appropriate Pillar 2 requirements

Encourage the effective management of risk and capital over the economic cycle

Banks need to be encouraged to manage risk and capital more effectively across the economic cycle. They should understand, analyse and manage the effects of economic and credit cycles on risk and capital thoroughly in order to protect themselves from procyclical effects. An enhanced Pillar 2 framework of stress tests and additional adjustments combined with more effective supervision can be used to encourage this behaviour.

Examples of effective management of risk and capital over the economic cycle include:

- Advanced capital planning for the effects of procyclicality by both setting capital levels and understanding how to maintain regulatory capital surpluses during downturns;
- Performing stress testing on individual bank risks and systematic risks, such as procyclicality, as a fundamental input into the capital planning process;
- Understanding and managing the interactions between liquidity risk and other risk types;
- Creating more rigorous scenarios to assess potential effects of procyclicality;
- Use of through-the-cycle risk models and understanding the procyclicality of current models;
- Setting lending underwriting standards in accordance with capacity over the entire economic cycle; and
- Improving the collaboration of Risk and Finance functions through the creation of joint governance committees to better understand the interaction of the two main aspects of capital management.

Use firm-specific stress tests with a macro-prudential overlay

In order to reduce the procyclical effects of excess credit growth, we believe that the principal focus should be on firm-specific stress testing of capital plans complemented by supervisor-defined macroeconomic system-wide stresses.

We would support a more targeted approach in encouraging banks to effectively manage risk and capital across the economic cycle through the use of existing Pillar 2 stress tests. The targeted Pillar 2 approach promotes proactive risk management and it will directly meet the objective of

protecting banks from the effects of procyclicality, included the risks caused by excessive credit growth.

Further Pillar 2 adjustments could be taken under an enhanced framework which would allow national regulators to take into account the differences in individual bank business models and the relative sophistication and quality of their risk and capital management frameworks.

National regulators may place additional macro prudential overlays to moderate the excessive credit growth in specific markets. The overlays would be calculated at a national level to moderate excessive credit growth and then allocated within the banking system with individual bank Pillar 2 adjustments.

Rather than having multiple individual buffers, we believe that a countercyclical buffer should be handled within the umbrella of a single Pillar 2 buffer. Guidance should be given to banks and supervisors as to what needs to be considered when determining the Pillar 2 buffer, which could include the items intended to be addressed by the various separate buffers currently proposed. In a number of countries Pillar 2 already includes a forward-looking capital stress test, and there is no reason why the various elements considered by the BCBS in the December 2009 and July 2010 papers cannot be brought within the coverage of that test.

It may be argued that Pillar 2 did not serve the system well during the crisis and/or that supervisors find it hard to assess a bank's capital plans and stress tests, but we would counter that (1) Pillar 2 had not really come into force in most jurisdictions when the crisis hit, and certainly not during the build-up to the crisis, when it would have been most beneficial; and (2) if supervisors are not adequately equipped to assess bank's own capital stress tests they are unlikely to be adequately equipped to impose additional capital requirements themselves. The solution to supervisory shortcomings is not to burden the system with unnecessarily high and mechanical capital charges, but to improve the quality of supervision (at a fraction of the cost).

Set buffer explicit release criteria

If a countercyclical buffer is set, explicit measurable criteria should be defined by supervisors to determine when the countercyclical buffer may be used and revert to zero. This is important to ensure that, once set, a buffer does not become a permanent capital add-on.

Evaluate the interaction with other proposals

Countercyclicality cannot be addressed in isolation. The interaction with the proposed changes to the minimum capital requirements, changes in provisions and the capital conservation buffer needs to be studied in order to assess fully the implications of the proposals. However, this cannot be done yet, as some of the other elements have not been finalised. We recommend that there should be a full set of proposals issued for comment, and a thorough and detailed impact assessment. We recommend that the Committee consider these interactions and the extent of double-counting as part of the further work on capital buffers that is planned for the remainder of 2010.

Use ongoing data to calibrate countercyclical capital adjustments

Countercyclical adjustments are difficult to calibrate given the requirement for long runs of data. Much further work needs to be carried out to identify the appropriate macro indicators to inform the setting and release of buffers. Ongoing analysis is also essential to determine the extent of cyclicality of Pillar 1 minimum capital requirements which has an important bearing on any subsequent buffer. We would therefore recommend that the Basel Committee specify the terms of

reference for such an ongoing study and that the results be used to refine the Pillar 2 methodology over time.

We also believe that there would be merit in assessing the through-the-cycle capital requirements of the banking system from first principles. Without this assessment it is difficult to have a robust view of where overall capital levels should rest.

Use other targeted macro-prudential tools

Targeted macro-prudential tools can be useful to prevent credit or asset booms in particular markets by constraining their activities. For example:

- *Applying flexible loan to value (LTV) limits on mortgage lending can be used to target specifically the mortgage sector*. As employed by many Asian regulators, adjusting LTV limits on mortgage lending can help prevent excessive credit entering the property market. Such adjustable limits can help constrain banks from taking excessive risks that may cause credit booms: in upswings, lowering limits to require higher mortgage deposits can act as prevention against property booms and, in downturns, raising limits to allow for lower mortgage deposits can encourage mortgage lending.

- *There should be improved oversight over banking practices of lending criteria and self-certification.* Regulators should put more emphasis on the lending criteria that banks employ and encourage the setting of minimum standards across the banking sector to militate against exuberance and excessive risk taking. This should include assessment of sector and lender concentration trends.

2 Our comments

While we fully support the objectives of reducing the impact of procyclicality on banks and the economy, we have a number of concerns with the current proposals, which we group as follows:

- Fundamental
- Operational
- Methodology

Fundamental

Buffers on buffers. Our overarching concern is that the BCBS approach to capital buffers is leading to extensive double-counting, increasingly complex calculations and lack of transparency. The prime responsibility for the management of the risk of excess credit should be with the institutions themselves and the supervisory process should be designed to ensure that this is the case and not to focus primarily on such mechanistic calculations. As the chart attached at the end of the paper indicates, 11 adjustments, buffers and other add-ons could be required for a bank to calculate its target Core Tier 1 ratio. It is therefore important that the countercyclical buffer proposal is considered in the context of these other changes and not in isolation.

Currently, the countercyclical buffer overlaps the conservation buffer, the systemic buffer that may apply to some institutions, and the through-the-cycle adjustments to Pillar 1. Rather than an incremental style, we believe that a holistic approach to buffers using Pillar 2 would be more effective. Given that credit bubbles are relatively infrequent (expected to be a 10 to 20 year event) a simpler targeted approach might be more effective.

The fundamental question of what the right level of capital is for the system remains unanswered. The approach is to look at incremental changes from where we are (which has its roots in the Basel I 8% ratio) rather than to assess requirements from first principles.

The objective of protecting against and moderating excess credit growth is narrow. The causes of the financial crisis were not limited to excessive credit growth. Future financial crises may be also be caused by other factors. It is envisaged that the countercyclical buffer for a given country will be only used every 10 to 20 years, which is more frequent than the expected reduced frequency of financial crises envisaged by the recent BCBS and FSB MAG studies - as a result of the higher capital levels already implemented as a result of the amendments to Pillar l. There is an opportunity to join up the thinking between these studies and this proposal..

The effect of a mechanistic approach to capital buffers will move decision-making on risk and capital away from banks and could create moral hazard. The consultative document details the implementation of a systematic buffer add-on approach where the main parameter is determined by national jurisdictions. This transfers the onus of a critical part of bank management into the hands of the regulators. This will create a moral hazard and is likely to encourage ‘lazy banking’ by taking major decisions on risk and capital away from the bank and placing them with the supervisor. It could also make it potentially easier for a supervisor to avoid looking at individual institutions. Leaving discretion to local supervisors in setting inputs and assumptions for determining capital buffers is also unlikely to create consistent regulatory capital standards globally.

The definition of “excessive credit growth” varies between mature and developing economies. For developing economies, starting at a low level of bank lending, one would expect to see much higher credit growth rates relative to GDP than in a developed economy. In defining excess credit growth, one would need to consider carefully the specific growth-stage context in each jurisdiction.

For example, a relatively fast expansion of micro-credit could be beneficial to economic development.

Operational

There will be significant difficulties in assigning banking exposures to countries under consistent definitions. This will cause ambiguity and create the ability to manipulate. For example, if a UK bank lends money to a German conglomerate that passes the funds to its Singapore subsidiary which invests in a mine in Indonesia, which country will the exposure be classified under? Credit exposures may be classified according to the exposures' country of risk, domicile, booking entity, or other factors. It will be hard to set a definition that avoids a wide degree of interpretation. The calibration of countercyclical buffers will be complex and require an extensive amount of input data over long periods of time. Even with accurate and extensive data, it will take multiple economic cycles to understand the impact of countercyclical buffers and calibrate them effectively using leading indicators of systemic risk and an appropriate amount of backtesting. Even then the past will only ever be an approximate predictor of the future. In our view a simpler approach would be more effective.

Impact on capital planning. Despite the 12 month rule, banks will face significant operational difficulties with respect to their medium-term capital planning, as this will need to take into account the future geographic distribution of their portfolios as well as the anticipated (or announced) capital buffers applying to individual jurisdictions. This requires a level of detail in the forward looking planning that is not normally present and adds to complexities introduced by other parts of the December proposals.

Methodology

The combination of macro tools and micro measures may not achieve the objective and could double count risks. The proposal would calculate country buffer add-ons for each bank based on its country exposures. The country buffer add-ons are determined by movements in macro metrics, such as the credit-to-GDP gap. This approach fails to deal with the issue that asset bubbles are normally confined to one or two asset classes. In our view, an approach that penalises all exposures in a country, regardless of the asset class, misses the mark and more targeted micro-level tools (such as maximum LTV ratios for mortgages) would be better suited to the problem.

The proposed approach taken would impose a 'one size fits all' approach to exposures regardless of the underlying asset classes. Pre-crisis, this would in our view, have done little to curb the flood of 'hot money' into sub-prime mortgage securities and similar assets where high credit asset price spreads were observed. Prior to the financial crisis, these activities were regarded as highly profitable and we believe that they would still have attracted investment even with higher host-jurisdiction capital buffers. It is doubtful in our view that capital buffers will prevent asset bubbles because a map or contributory factor is increased profitability and capital availability.

There is a risk of over-compensating against the build up of excess credit, with other capital buffers and individual jurisdictions using their own micro-prudential tools, such as LTV caps, to address excess credit in the system. If individual jurisdictions currently use different sets of tools to manage excess credit, an application of an indiscriminate countercyclical buffer will have differing effects in different jurisdictions - creating market distortions and opportunities for arbitrage. The inter-connection of other proposed tools, such as forward-looking provisions, will be complex and the impact is not yet fully understood.

Data inconsistencies and differing supervisory judgements across countries will make it almost impossible to create a level playing field in setting countercyclical capital buffers. The appropriate

setting of the country buffer add-ons requires reliable, consistent data and harmonised judgements to be employed by all jurisdictions. Inconsistencies in data will arise due to variable sources, quality and level of historical data available. For developing economies, the availability and quality of time series data will be not be sufficient to make accurate, informed judgements. A wide range of regulatory skills and capabilities would be required to determine the add-on buffer.

Even with home authorities having an ability to adjust foreign host authority settings, they will not be able to remedy these inconsistencies. The home authorities will not have the necessary data or time to make these judgements in relation to the conclusions of all the other jurisdictions.

The interaction with monetary and fiscal policy is complex and will require extensive central bank co-ordination which is not currently present. In normal circumstances, monetary policy is used to manage the supply of credit. The interaction between setting of interest rates and the capital buffer add-on will be an important consideration. Clearly the setting of the country buffer add-on will have a material effect on interest rates and vice-versa. There should be more work performed to understand this relationship better.

The approach also implies that there is effective interaction between Central Banks responsible for monetary policy and the regulators. This is likely to be an issue in some countries. Even in those countries where the regulator is part of the central bank coordination may be difficult. The current proposals do not define how this interaction should work in practice.

There is a significant risk of political considerations affecting the setting of the country buffers. There is a risk of politicisation of the regulatory view of the economy signalled in the buffer add-on. It will be difficult for national regulators to be able to make independent decisions without the influence of their political system. For example, in the current economic climate, views of future economic expectations are highly politicised, and some are closely linked to sovereign ratings.

The changes to country add-on buffers could trigger a self-fulfilling prophecy. In effect the proposed approach will require a central bank to announce the next recession – as far as we are aware no central bank has ever done this. A change in the buffer will formalise the authorities' view of a tipping point in the credit cycle which will create a risk of prompting institutions to decrease/ (increase) their exposures. Such an announcement will be a key piece of information for market analysts and investors. Also, with an increase in add-on buffers, the demand for several banks to raise capital ratios simultaneously may act as a trigger to reduce the credit supply. The risk of a self-fulfilling prophecy is also something that will force the decision to become politicised. To counteract this risk, governance of buffer-setting should permit regulators to exercise independent judgement - which may not be possible in all jurisdictions.

The diversification of country exposures for international banks will give them a competitive advantage, compared to locally operating banks. As noted within the consultation paper, international banks are likely to have a smaller maximum and a narrower range of countercyclical buffer add-on imposed. International banks may benefit from diversification through flexible allocation and pricing of capital across jurisdictions. Although experience has shown that bank behaviour is more likely to be influenced by the marginal cost of credit applicable to exposures in the jurisdiction, as identified in the consultation paper, international banks will at least have this flexibility under these proposals and may seek to exploit the competitive advantage should the opportunity strategically arise.

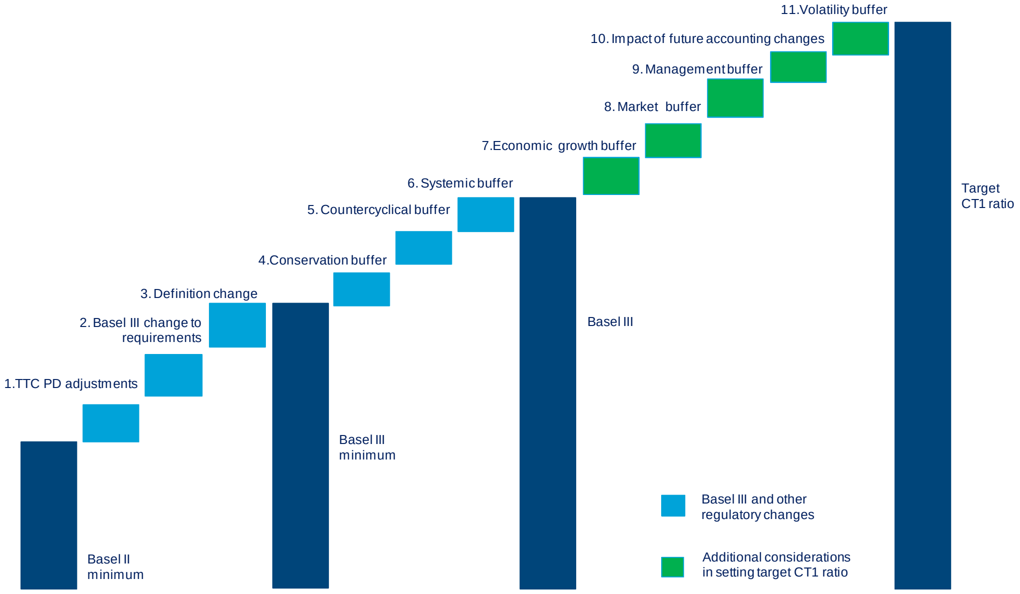
In addition, at the point of buffers being introduced, locally operating banks may face additional marginal costs in raising capital during a period of increased levels of capital demand, where international banks are likely to be able to reallocate capital from other jurisdictions. This will put the locally operating banks at a further disadvantage to the international banks.

Appendix

The context for countercyclical buffers

The countercyclical buffer proposal should be assessed in the context of other Basel III changes and components in developing overall target Core Tier 1 ratios.

The countercyclical buffer proposal should be viewed in context



There are six overlapping changes proposed by Basel (coloured blue in the chart above) and five further potential add-ons (coloured green). The countercyclical buffer (number 5) overlaps the conservation buffer (4), the systemic buffer (6) that may apply to some institutions, the economic growth buffer (7) and the through-the-cycle adjustments to Pillar 1 (1).

The changes to RWA calculations and definitional changes are shown for completeness (2 and 3). These are not strictly buffers but increase the Core Tier 1 ratio in old money terms – and therefore the capital that banks need to hold and the level of capital in the system.

Other add-ons include a management buffer (8) and a market buffer (9). These two add-ons, which have always existed, are used by banks to provide a safety margin above the regulatory minimum and to meet other stakeholder requirements, for example, those of rating agencies. Future accounting changes (10) are uncertain as they are not yet defined. For example, forward-looking provisioning will impact the expected loss/accounting impairment adjustment. Over the cycle, the effect will probably be to reduce average retained earnings.

The definitional changes to regulatory capital (for example the treatment of deferred tax assets and pension liabilities) increase cyclicality in the Core Tier 1 ratio. This means that affected banks would need to hold an additional buffer element to absorb this volatility (11).

Lastly, although not a Basel requirement, some central banks e.g. the Bank of England, have also proposed that banks should hold a buffer (7) to allow them to stimulate economic growth after a downturn. This directly overlaps the countercyclical buffer. It also seems implicitly to assume that stimulation of growth after a recession is principally a question of credit supply. Such an approach takes no account of investors' intolerance for redundant equity capital which would make banks that are subject to such a requirement unattractive to equity investors.

pwc.com/uk

Designed by Design & Production, FS, Assurance (24745)