RESERVE
BANK
OF NEW ZEALAND

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Basel Committee on Banking Supervision
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Dear Stefan

Countercyclical Capital Buffer Proposal

The purpose of this letter is to offer some comments on the Countercyclical Capital Buffer proposal that was issued in late July.

The Reserve Bank of New Zealand has a strong interest in the use of macro-prudential tools and other instruments that could assist with macro-financial stabilisation. This is an area we have been researching over a number of years. We believe this is a complex area and the suitability of particular tools is likely to vary depending on individual country circumstances. Thus while the broad principles set out in the countercyclical capital buffer proposal are useful, we believe considerable flexibility would be required in using the tool in individual countries. We do not favour a one-size-fits-all approach.

The consultative document provides a clear description of the objective of the buffer and how it could operate in practice. The primary objective stated in the proposal is to protect the banking system from the consequences of excessive credit growth. The proposal notes that the effectiveness of the buffer in dampening the credit cycle remains unclear. However, in our view, a primary goal of macro-prudential policy needs to be the prevention of periods of excessive credit growth rather than just the protection from its consequences. Accordingly, we believe further analysis is warranted into the extent to which the buffer might usefully affect credit growth. In addition, further work is needed into the viability of tools that can help to mitigate excessive credit growth before a firm view can be reached on the overall merits of the buffer proposal.

An issue that we feel did not receive sufficient attention in the proposal is the size of the capital buffer that banks might need to carry if the macro-prudential goal of cushioning the credit cycle during a downturn is to be achieved. It is well recognised that when banking systems undergo crises, markets tend to impose more stringent de-facto capital requirements on banks. It is this phenomenon that partly accounts for credit crunches – banks adjust by shrinking assets. Thus, if the purpose of the capital add-on is to prevent the banking system from shutting its doors when a large credit bubble finally bursts, the margin of extra capital required might be quite large. On

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that score, the 2 percent maximum buffer used in the proposal for illustrative purposes seems likely to be too small.

Another point not covered in the proposal is whether the buffer would be predetermined or varied in size depending on the particulars of the cycle. Moreover, it was not clear from the proposal whether jurisdictions would be free to choose the size of the maximum buffer to reflect the level of risk facing their domestic banking systems.

In our view, further thought needs to be given to the potential financial system efficiency costs associated with the use of the buffer and the conditions under which it might fail to have its intended effect on the financial system as a whole. The application of the buffer to banks rather than other financial institutions or lenders raises the risk of financial disintermediation, which could entail significant economic costs and/or undermine the overall purpose of the buffer. This would be particularly so if excessive credit was being generated from outside the domestic banking sector. Although the buffer could in principle be extended to non-bank lenders, this could be practically difficult.

The proposal notes the difficulties associated in determining when to release the buffer. This choice is made difficult by the fact that a downturn will not always be associated with the immediate realisation of the risks for which the buffer has been imposed. This may be a particular issue when the credit cycle turns but the economy in question continues to face accumulated imbalances built up over several cycles that may pose risks for the banking system for a considerable period into the future. One school of thought would hold that the buffer should be released in a timely fashion to ensure that credit continues to flow sufficiently during the immediate downturn. An alternative view is that the buffer requirement should be retained, possibly for some years, until such time as the accumulated imbalances and risks are realised. Given these differences in view, further consideration of the costs and benefits of different strategies for the release of the buffer appears warranted.

Much of the proposal focuses on the role of the Private Sector Credit-to-GDP gap as a central indicator in guiding the application of the buffer. However, the proposal acknowledges that a range of other indicators may be useful and also highlights the need for the authorities to use judgement in the application of the buffer. We think these conclusions are sensible. Our own analysis of the Credit-to-GDP ratio for New Zealand, based on the methodology set out in the proposal, highlights a number of shortcomings.

First, calculations of the credit-to-GDP gap appear to be highly sensitive to whether the analysis is conducted in real time or on the basis of historical data. This partly reflects the well known end-point problems associated with statistical filters as well as data revisions. Second, our analysis suggests the potential for false signals. For example, volatility in GDP can drive a sudden change in the gap even if credit activity is unchanged. Third, calculations of the gap appear to be sensitive to the particular measure of credit used meaning that no single credit measure can ever tell the full story.

Finally, and more fundamentally, we are not convinced that a gap approach necessarily reflects the accumulation of financial system risk. Sustained periods of strong credit growth over long periods may become part of the trend and thus appear innocuous using gap analysis. Alternatively, in some cases, the suggested calibrations could result in the capital buffer being in place for a number of years that span several business cycles, particularly where the economic downturns do not involve financial distress to signal the release of buffers. Under these circumstances, the higher cyclical capital requirements could come to be viewed as the de-facto minimum.

Overall, we believe the capital buffer is potentially a useful macro-prudential tool for managing periods of excessive credit growth in the future. However, application of the buffer would call for a careful assessment of credit conditions and other factors within the country in question. We believe pre-determined robust policy rules to apply to all countries are neither possible nor desirable. Thus while the proposal has set out some useful principles, adoption and practical use of the tool would need to be determined by individual country authorities.

Thank you for the opportunity to comment on this proposal.

Yours sincerely

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