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Mr. Stefan Walter
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

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Dear Mr. Walter

BCBS 172: Consultation on Countercyclical Capital Buffer Proposal

I am writing to provide The Royal Bank of Scotland's ("RBS") response to the above consultation. We summarise below our principal observations on the proposal; the attachment to this letter expands on these and provides more detailed comments on specific aspects.

Let me start by stating that RBS fully supports the principle of a less pro-cyclical capital framework, as well as the four key objectives set out by the Committee in its December 2009 Consultative Document (*Strengthening the Resilience of the Banking Sector)* for framing measures aimed at addressing cyclicality.

Turning to the specific proposal in the consultation, however, we have a number of significant concerns, which lead us reluctantly to conclude that they do not provide an effective answer to delivering on these objectives. We fear they may even prove counter-productive, and that there are potentially better ways of delivering a less pro-cyclical framework. We touch on these alternatives below.

Our concerns are essentially three-fold:

1) The proposal as designed gives rise to a number of conceptual and implementation difficulties, which call into question its practicality and effectiveness.

Notably, the interaction between this proposal and wider issues of macro-economic management has yet to be fully addressed. The proposal also raises methodological questions and concerns over potential redistribution effects. Finally, it is likely to prove complex to implement in practice, due to the granularity of information required.

2) The need for such a tool has diminished significantly, given the number of other measures addressing pro-cyclicality that have recently been implemented or are in the process of being developed.

Changing internal models towards "through the cycle" methodologies, and building stress tests into model approvals, are just two examples of ways in which the capital regime has already been strengthened in response to the crisis, and which directly address the objective of reducing pro-cyclicality. Other planned measures such as forward-looking loss provisioning will further address cyclical effects.

3) Following on from the above, we are concerned about the risks of excessive conservatism in capital requirements that the proposal threatens.

Not only does the proposal create an additional over-lay on other buffers and conservatism built into the capital framework, but the ability to draw down on buffers seems to us doubtful. It also poses risks of trapped capital, and is likely to lead banks to anticipate the need for buffers in advance of official requirements, given the nature of capital planning processes.

In short, we believe the buffer proposal as currently specified poses significant issues that call into question its effectiveness as a tool for delivering the stated objectives. Because of this, we would suggest instead consideration of alternative approaches, such as use of the Pillar 2 framework (as described further in the attached).

If, on the other hand, the Committee feels it necessary to stick with a Pillar 1 approach, then we would urge a simplified regime that would address some of the implementation and operational issues of concern (again, some suggestions are made in the attached).

In either case, we would also continue to urge the authorities to consider carefully the effects of the overall regime, such that all the planned capital and liquidity changes are collectively taken into account. We would encourage greater openness in terms of the QIS results and macro-economic impact assessments, to facilitate a more open dialogue as regards aggregate impacts.

We would of course be very happy to meet the Basel Committee, its Secretariat or individual regulators to explain our views in more detail.

Yours sincerely

Nathan Bostock

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Attachment: RBS response to BCBS 172

Conceptual and Implementation Issues

(i) Macro-economic management

Although the proposal states that the aim is primarily to protect the banking sector from the credit cycle through the build-up of capital, and that any positive impacts in terms of moderating excessive credit growth should be viewed as side benefits, the proposal cannot be separated from wider consideration of macro-economic management, and the context set by governments and central banks via (respectively) their fiscal and monetary policies.

In our view, the countercyclical buffer proposal would not sit easily with such policies if they were not closely co-ordinated with other each other and consistent in their policy bias. Countercyclical buffers should not be used to lean against excessive growth in the system, to make up for the absence of policy action in other areas. Counter-cyclical buffers can directly impact the supply of credit, but demand issues (more directly impacted by monetary and fiscal policies) need to be taken into consideration as well.

A coherent macro-economic policy approach is required, with any counter-cyclical buffer integrated into wider macro-economic management instead of being used by regulators independently of other agencies. We would therefore urge the Committee to work together with the FSB to ensure there is a consistent application of macro-economic management tools, including any countercyclical buffer.

(ii) Methodological questions

Conceptually, the sole use of a credit to GDP ratio is a simplistic way to determine the appropriate size of a countercyclical buffer. We do not doubt the Committee's work on identifying this as the best single measure. However our work suggests that to capture recession risk and calibrate the build-up of capital would require more than a single measure. This would however increase further the complexity of a countercyclical measure, something that we would further compound the workability of proposals. We note this simply to point out that fundamentally the countercyclical buffer is already a compromise between accuracy and practicalities. We think that this balance should be tilted further towards addressing practicalities.

To illustrate the above, it is generally observed that in the run-up to a downturn it is the quality of credit that suffers. Therefore a pure quantum based measurement such as the credit to GDP ratio may miss key risk factors. This suggests that any quantum based measure can be adjusted to reduce operational burdens without undermining the Committee's aims.

(iii) Redistribution effects

We also note that the use of countercyclical buffers is likely to have redistribution effects in the real economy. Smaller companies, that are reliant on bank funding, will not be able to escape the additional costs the proposals will create. However, larger companies, particularly those that can access the global capital markets, can access alternative sources of finance that do not incorporate the cost of the countercyclical buffer. They would thus gain unjustified commercial advantage in comparison to their smaller competitors. It is not clear to us why this would be in the public interest.

Similarly, we think that the proposals risk creating an unnecessary crowding out of lending by the regulated sector, as funding from outside of the banking industry would not be hit by the counter-cyclical buffer.

(iv) Implementation issues

The implementation of systems necessary to make the counter-cyclical buffer work is not straightforward. The concept of assigning an exposure to a country requires analysis of income streams, asset locations and credit mitigation, with regards to which there may be differing levels of sophistication between institutions. Although this can be achieved through due diligence, supported by suitable processes and systems, there is also a need to ensure consistency. The cost of doing this due diligence is not in our view likely to be proportionate to the benefit of a countercyclical buffer, the goals of which can be achieved via other macro-economic measures.

Trading book exposures raise particular issues in this regard. An initial difficulty might be to achieve a unified definition as to what an exposure is in the context of a trading book – for instance, whether it is a net exposure (after hedging) or a notional exposure.

Another example would be how to treat the locality of instruments issued in off-shore centres or euro-markets. Presumably the credit to GDP growth of an off-shore centre would not be meaningful for the calculation of an appropriate countercyclical buffer. Nevertheless, banks would hold many exposures that are in a first instance to an entity based in an off-shore centre. If it is the intention of the Committee to force banks to look through the capital funding of companies to the location of the ultimate use of funds, this would create significant additional on-going monitoring costs to the working of the proposed buffer.

Measures already taken to address pro-cyclicality

We fully understand regulators' desire "to ensure that banking sector capital requirements take account of the macro-financial environment in which banks operate." Changes in the regulatory landscape already implemented and in train have already achieved much in this regard, for example by:

- Changing models towards through the cycle methodologies.
- Building stress tests into model approvals, for example in CRM, and using downturn LGD assumptions.
- Improvements in stress testing more generally, often including severe downturns assumptions.

- Increasing the robustness of forward looking stress tests through supervisory actions.
- Strengthening the definition of capital with more deductions from Tier 1 capital and clearer loss absorption criteria.
- Introducing a Leverage ratio as a backstop measure.
- Introducing a Stressed VaR and Incremental Risk Charge.

Further movements in that direction are envisaged by moving from an incurred loss accounting regime to an expected loss approach. The fundamental review of the trading book announced by the Basel Committee will also look at reducing pro-cyclicality in trading activities, thus also addressing some of the concerns that gave rise to the countercyclical buffer proposals.

Given the above, we would argue that the need for a counter-cyclical buffer to address pro-cyclicality is questionable. In our view, the introduction of an additional countercyclical buffer regime would only be compelling if it created more than a marginal improvement in financial stability – given the multiple other initiatives in hand, we doubt whether that would be the case.

Risks of Excessive Conservatism

The buffer proposal would provide an additional overlay on top of other buffers and increases now being built into the new framework. However, we doubt that the official release of a countercyclical buffer would provide an unfettered ability for a bank to release the capital surplus. Rather, such a release is more likely to be interpreted as a sign of forthcoming stress, thus increasing market pressures on banks to hoard capital. As a result, firms risk in practice not being able to release any funds until they make losses, at the same time as the capital conservation buffer would be eaten into. The proposal therefore could perversely worsen rather than mitigate economic downturns.

The proposals also make capital planning much more complex, as firms would have to integrate another level of uncertainty about the respective levying or releasing of the countercyclical buffer during the period covered by their capital plan. Indeed, it is quite likely that firms would feel obliged to anticipate the need to hold a countercyclical buffer, given lead-times in capital planning and raising.

A further cost may arise if individual countries required a countercyclical buffer at the level of their respective jurisdictions. We do not see that such trapped capital would significantly improve financial stability, while it could reduce the ability of groups to support subsidiaries. We would therefore urge the Committee to clarify that any countercyclical buffer would only be applied at the consolidated level.

Alternatives

Given the above, our conclusion is that the counter-cyclical buffer as proposed does not provide an effective answer to delivering on the objectives of addressing pro-cyclicality. Whilst we also have serious doubts about the need for a counter-cyclical buffer more generally, given the various other measures identified above that are being implemented, we accept the need to give authorities the tools they need to ensure sufficient capital is built up by banks.

Our preference would be that the Basel Committee develops guidelines to ensure a level playing field in the use of stress testing, as we feel that countercyclical issues would more easily sit in a Pillar 2 framework. Under Pillar 2, a capital buffer could be set so as to take account idiosyncratic elements (such as risk appetite, lending criteria, business strategy and risk management frameworks), relevant to addressing business cycle concerns on a more tailored and targeted approach. Involving colleges in setting such countercyclical buffers would provide for an element of benchmarking that would help address level playing field issues.

However, should the Basel Committee feel it necessary to stick with a Pillar 1 approach, we would suggest an operationally much simpler determination of the countercyclical buffer. Our main concern is that the costs of operationalising and maintaining the necessary systems and processes for a buffer that may only be used infrequently are out of proportion to the benefits.

Given difficulties with correctly allocating trading book exposures for these purposes, one simplification might be to rely on banking book exposures (where country information is readily available and relatively clear-cut) to determine the geographical exposure of a banking group. At the same time, the granularity of such a measure would not need to go down to the exposure level, with broad approximation of country exposures being sufficient.

Overall, we do not think that using more approximation would undermine the objectives of the Committee. Moreover, it should enable banks to rely on existing country risk management systems.

Again, involving colleges into this process would help with consistency of implementation.

Conclusion

We are of the view that the difficulties of implementing a workable countercyclical buffer have been significantly underestimated by the Committee and the proposal as issued would not achieve the aims of the Committee. As indicated above, we think that there are alternatives available to the Committee, if on the basis of its calibration, it was to determine that a buffer was required to achieve desired capital levels.