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September 10, 2010

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland
Delivered via e-mail to baselcommittee@bis.org

RE: Response to Consultative Document, *"Countercyclical capital buffer proposal"*

Ladies and Gentlemen:

Thank you for providing The Risk Management Association (RMA) the opportunity to comment on the Basel Committee on Banking Supervision's Consultative Document "Countercyclical capital buffer proposal" (BCBS 172) published in July 2010. RMA, a member-driven professional association, helps banking and nonbanking institutions identify and manage the effects of credit, operational, and market risk on their businesses and customers. The Capital Working Group (CWG) of RMA prepared this response; the CWG has been providing independent analysis on matters pertaining to risk and capital regulation since its inception in 1999. Since its inception, the CWG has stressed that capital requirements should always, as accurately as possible, reflect the risk associated with bank exposures. Capital requirements that are not accurately risk-based, whether too low or too high, can harm bank soundness.

The consultative document is aimed at achieving a macro-prudential goal of protecting the banking sector from periods of excess credit growth. While we have sympathy for this goal, we do NOT believe that a generalized capital buffer as a whole can be as effective as proper supervision of underwriting standards or proper specification of risk-based capital requirements in heading off future excessive credit booms. Indeed, the Committee has recognized the shortcomings of the previous Basel II generation of minimum capital requirements and has taken significant steps to improve the risk-based nature of the capital requirements going forward (the reforms pertaining both to credit risk and market risk). Further, new supervisory emphasis on origination procedures and other Pillar 2 initiatives—including new supervisory emphasis on Pillar 2 stress-testing and new Pillar 2 requirements for understanding the loan portfolios underlying securitizations—will, in our view, bear the burden of protecting against future credit excesses.

The countercyclical capital buffer, in contrast, exhibits certain unknown effects and certain other known but unintended consequences. We believe that implementation of a macro-economic-factor-based, one-size-fits-all capital add-on cannot be achieved without very serious consequences. Therefore, in the attached response, we offer specific concerns regarding the proposal.

Please feel free to contact Ed DeMarco via email at edemarco@rmahq.org or Sue Wharton via email at swharton@rmahq.org.

Sincerely yours,

Edward J. DeMarco
General Counsel

Suzanne I. Wharton
Associate Director, Enterprise Risk

cc: Federal Reserve Board; Comptroller of the Currency; Federal Deposit Insurance Corporation (via e-mail).

September 8, 2010

Response to BCBS 172 (Countercyclical capital buffer proposal) by the RMA Capital Working Group

I. Introduction and main concerns

The RMA Capital Working Group (CWG) appreciates this opportunity to comment on the July, 2010 Consultative Document dealing with the Basel Committee on Banking Supervision's (Committee) countercyclical capital buffer proposal. The CWG consists of senior officers in the field of risk measurement and management, and the management of capital positions, at major U.S. financial institutions.[1] Since its inception in 1999, the CWG has stressed that capital requirements should always, as accurately as possible, reflect the risk associated with bank exposures. Capital requirements that are not accurately risk-based, whether too low or too high, can harm bank soundness.

In this context, we should like to begin by addressing the four goals specified by the Committee within the July Consultative Document:

- To dampen excess cyclicality of the Pillar 1 minimum capital;
- To promote more forward looking provisions;
- To conserve capital to build buffers that can be drawn down during stress periods; and
- To achieve a broader macro-prudential goal of protecting the banking sector from periods of excess credit growth.

These goals are not objectionable in and of themselves. However, attempts to achieve the goals may conflict with the paramount goal of maintaining capital requirements that vary with risk, so that, no matter where in the credit cycle we are, banks will not be induced to take on high levels of risk without paying the price in terms of high levels of capital.

The Consultative Document itself is aimed at achieving only the fourth goal in the Committee's list of goals. While we have sympathy for this goal, as we do the others, we do NOT believe that a generalized capital buffer *as a whole* can be as effective as proper supervision of underwriting standards or proper specification of risk-based capital requirements in heading off future excessive credit booms. Indeed, the Committee has recognized the shortcomings of the previous Basel II generation of minimum capital requirements and has taken significant steps to improve the risk-based nature of the capital requirements going forward (reforms pertaining both to credit risk and market risk). Further, new supervisory emphasis on origination procedures and other Pillar 2 initiatives, including new supervisory emphasis on Pillar 2 stress-testing and new Pillar 2 requirements for understanding the loan portfolios underlying securitizations will, in our view, bear the burden of protecting against future credit excesses.

The countercyclical capital buffer exhibits certain unknown effects and certain other, known but unintended consequences. These concerns do not detract in the least from the path-breaking

[1] An appendix lists the names of institutions and staff that assisted in the preparation of this response. Individual institutions may disagree with specific points made in this response and/or may be providing a separate response to the Consultative Document.

economic research conducted by the Committee staff. Rather, we believe that implementation of a macro-economic-factor-based one-size-fits-all capital add-on cannot soon be achieved without very serious consequences. Much more study and informed debate needs to take place before even a trial period could be initiated. In that spirit, we stand ready to assist the Committee in any way we can. Toward this end of informed debate, we offer the following specific concerns regarding the proposal.

II. The countercyclical capital buffer proposal's shortcomings.

Our major concerns with the counter cyclical capital buffer are outlined below:

A. Interaction of the proposal with other buffer requirements of Basel. In particular, under Pillar 2 ICAAP procedures, each bank should engage in stress-testing and other methods (such as Economic Capital methods) to determine the level of capital the bank should hold as a buffer above the Pillar 1 minimums. Significant emphasis has been placed by financial institution supervisors on the stress test procedures and, in the U.S., the new financial reform legislation requires that the federal banking agencies lay out specific requirements for the stress-testing process.

   Stress-testing methods vary considerably across institutions, but many banks set as a standard that, once a suitably adverse stress is chosen, the post-stress resulting regulatory capital ratios should be no less than the Pillar 1 minimums. That is, the bank must hold enough of a buffer above the current minimums, so that when the adverse event occurs, the banks will still be meeting the minimum capital standards after the stress is over. The combination of the capital conservation buffer plus the countercyclical capital buffer suggests that, at each bank, the result of stress-testing should be to have a set of post-stress capital ratios that are no less than the minimums plus the two buffers. This represents a degree of cumulative conservatism that is untenable, both from the point of view of allowing regulated banks to compete with unregulated financial institutions and to help manage a recovery by appropriately increasing lending.

B. Can the proposed countercyclical buffer actually be usable? First, evidence in the U.S. suggests strongly that capital buffers (such as the U.S.'s Prompt Corrective Action well-capitalized standard) become immediately viewed by the markets as new minimums. Banks are expected to keep buffers over and above these regulatory buffers so as to reduce to a satisfactory level the chance that the bank would become less-than-well-capitalized.

   Second, initiation by regulators of the countercyclical buffer could itself become pro-cyclical. That is, borrowers, worried about their future sources of funds, might draw down their lines of credit now -- and lead directly to an expansion of credit greater than otherwise.

   Further, it is likely that the existence of excess credit growth would not be felt equally across industrial sectors. That is, the imposition of a countercyclical capital buffer might

not be high enough to cure the frothiness in a particular sector, yet may constrain credit in sectors operating under normal conditions.

C. Interaction between the countercyclical capital buffer and other efforts by Basel to reduce pro-cyclicality.

1. The use of downturn PDs. The Committee proposes to dampen the pro-cyclicality of Pillar 1 requirements by using downturn PDs instead of average through-the-cycle PDs within the BII Asymptotic Single-Risk-Factor (ASRF) credit risk models used to set Pillar 1 credit risk capital requirements. This will raise capital requirements by using a stressed stress in the form of plugging a high PD into the ASRF models, then using the same 99.9% confidence interval embedded within the ASRF models. But a downturn PD will, in the longer run, result in no more stable Pillar 1 capital requirements than the average through-the-cycle (TTC) PD. This is because, once the banking industry has experienced one or more downturns such as the current crisis, each new year's data on realized default rates, when used to compute the TTC PD, will not alter the TTC PD by very much. Some years realized default frequencies will be higher, some will be lower, than the TTC average PD, but the average will not change much (as it did in the very first few years of collecting data to be used to estimate TTC PDs).

   All the downturn PD proposal does is add a further amount to Pillar 1 requirements -- another buffer during all points of the cycle. Again, this buffer could never be actually used, since the only result is an effectively higher minimum capital requirement.

2. The use of a constant, stressed EL for purposes of provisioning. On page 4 of the July 26 Annex, the Committee indicates that it has developed a concrete proposal to implement the expected loss (EL) approach to setting the level of the Allowance for Loan and Lease Losses (the ALLL as it is called in the U.S.). This concrete proposal apparently has not been made public, although the Annex refers to a letter sent to the IASB on June 30, 2010. Because the Committee is proposing the use of a stressed PD, it must presumably also be proposing the use of a stressed EL, since by definition EL equals PD times LGD (and the Basel II LGD definition is that of a stressed loss-given-default).

   Because the ALLL to be chosen is *stressed* EL, and is designed to be constant, the additional ALLL represents still another true capital add-on -- but one that cannot be reduced at any point in the cycle. This sort of cumulative conservatism, when combined with the countercyclical buffer being proposed by the Committee, could be disastrous to the regulated banking system's ability to compete with non-regulated financial institutions and to help finance the economic recovery.

D. Cross-country differences in the application of the proposal. The proposal indicates that the countercyclical capital buffer would be administered by individual countries' supervisory regimes. This part of the proposal is suggested by cross-country differences in the manner in which a macro variable (such as the difference between the credit/GDP ratio and its long-term trend) is statistically connected to, and has particular leading versus lagging degrees of correlation with, banking sector losses. We agree intuitively with such a preliminary finding. But the cross-country differences in either the size of the buffer or when it would be initiated or released could easily result in competitive inequities with regard to particular countries' banking sector profitability or soundness. Yet, we see no alternative, if the proposal moves forward, other than to have such cross-country differences. Since the academic basis for the proposal is not yet mature, we therefore believe that the benefits of the proposal -- if enacted any time within the next few years -- are outweighed by these possible inequities. We discuss the pressing need for further academic research in some of the sections below.

E. The buffer capital add-on versus country-specific capital ratio targets. Some countries' regulators have a highly developed sense of appropriately high capital ratios in order to deem a bank well-capitalized. In the U.S., for example, supervisors talking with individual banking companies often express a desire to see capital ratios of 8%, 10% and 12%, respectively, for the leverage ratio, the Tier 1/RWA ratio, and the Total Capital/RWA ratio. These desired ratios are significantly higher than the ratios required by the U.S. Prompt Corrective Action legislation in the early 1990's. It is unlikely that these comfort levels will match up easily with the Committee's proposals.

Indeed, the Consultative Document gives as examples, that the first of the two buffer proposals -- the Capital Conservation Buffer -- should be 2 percentage points in terms of the Tier 1/RWA ratio. The countercyclical capital buffer is then given an example of another 2 percentage points (again, in terms of the Tier 1/RWA ratio). Taken together, these two capital buffers would mean that during some future period that is determined to be a boom, Basel banking institutions would be subject to a minimum Tier 1/RWA ratio of 8% (the regulatory minimum of 4% plus the two 2% add-ons).

This level of expected capital buffer *during booms* is less than the current capital ratios being strongly suggested to U.S. banks during the *current crisis*! Even worse, during some future boom, U.S. supervisors might be tempted to add on another, buffer, if the Committee's proposal were enacted and if some macro-variable were deemed to be high enough in future good times. These add-ons would result in competitive inequities if applied in such a simple matter (because, in the example, the U.S. required ratios under supervisory standards might be considerably higher than the minimum ratios (including the 2 buffers) used in other countries).

Further, any use of multiples of base ratios can distort the risk-based nature of the carefully calibrated Basel credit risk models.[2]

[2] It is possible that as the base requirement is, say, tripled, the bank with the low-risk portfolio (lower Asset-Value-Correlations) might have to hold capital (as determined by the Basel ASRF credit-risk-capital models)

F. <u>The countercyclical buffer proposal could result in an increase in the degree of interconnectedness of regulatory regimes</u>. That is, one or two countries' use of the countercyclical buffer could weigh upon other countries to initiate their own buffer, even if the domestic empirical evidence is not sufficiently strong to warrant such initiation (or release). This possible behavior of the group of 26 Basel countries could add to global systemic risk -- the possibility that concerted global action to initiate buffers could hamper this or some future recovery or cut-off some future acceptable level of economic growth. The science of macroeconomic cycle-management is itself imprecise, even though it is many decades old. The interplay between traditional macroeconomic tools and some new banking-sector macroeconomic tool is essentially unknown, and thus the proposed macro-based capital buffer must wait for additional research.

Moreover, while it may be easy for the Basel countries to act in concert to initiate a countercyclical capital buffer, we do not think that release of the buffer will occur evenly, or at all, across the Basel community. That is, regulators would be much less likely to release the buffer than to initiate it. Indeed, the academic paper behind the proposal indicates that macro variables may not be ideal indicator variables for signaling the release phase. The Consultative Document itself is very specific with respect to when the capital buffer should be initiated, but it is silent on the release phase. Skeptics would say that this is an indication that regulators always want more capital, never less. Our concern, however, is that global concerted action on the initiation, but not the release, of the buffer is a recipe for disaster. We don't think the nature of regulators will easily allow the buffer to be used (to be released). Most importantly, the lack of academic evidence on how to initiate a release is itself a sufficient reason for delaying serious consideration of the proposal until the necessary research has been done.

G. <u>The countercyclical buffer is aimed at all banks in a particular country, whether or not those individual banks, or even the banking sector as a whole, caused the excessive credit growth</u>. In effect, the countercyclical proposal ignores the main purpose of Basel II and the now-being-implemented improvements known popularly as Basel III. This purpose was, and is, to increase capital requirements in relation to increased risk. Thus, if a particular set of banks in a particular country have continued to lend under appropriately conservative origination policies and have continued to add to their capital base in relation to the risk of these additional assets, such banks will likely NOT incur the losses that many banks realized during the current crisis.

Additionally, if the regulated banking sector as a whole continues to build capital properly in relation to risk, the sector as a whole would be insulated from the kinds of debilitating losses experienced during the crisis. The build-up of excessive credit would have been fostered by non-bank lenders, and it would be these non-bank (non-

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that increases its effective confidence interval above (lowers its insolvency probability below) that of the bank with the high-risk portfolio -- an unintended consequence of the application of simple multiples of minimum ratios.

regulated) lenders that would incur the bulk of the losses in the credit downturn that follows the excessive credit episode.

The Committee's proposal that the buffer be the same for all banks in a particular country may arise from the fact that, in many countries among the now 26 members of the Committee, there is no effective individual bank supervision. And where there is supervision, there is often not the 24/7 on-site type of supervision common in the U.S., U.K., and several of the other member countries of the Committee. In these supervision-intensive countries, we would argue for the imposition of any countercyclical buffer to be a) bank-specific, and b) a non-publicly-disclosed supervisory event, so as not to upset the market for the individual bank's stock and debt.

The timing of bank-specific buffers required by an individual Member country should also differ across banks. The best-capitalized (in relation to risk) institutions would experience a supervisory call for a countercyclical buffer *later* than other, more risky institutions (in relation to capital). Finally, the release of the countercyclical buffer should occur earlier in the recovery for the relatively well-capitalized bank (in relation to risk).

H. The countercyclical buffer could run afoul of the recently introduced minimum leverage ratio requirement. Only if the leverage ratio requirement were kept low enough to not interfere with the Tier 1/RWA countercyclical buffer would this problem be alleviated. To see this possible interaction between the Tier 1/RWA buffer and the leverage ratio minimum, consider the following example:

1. Suppose that, in response to a supervisory request to raise the Tier 1/RWA ratio to include a countercyclical buffer, banks enter low-risk AAA-rated positions and exit BBB-rated corporate loans. This would serve the countercyclical purpose, even though the leverage ratio would remain unchanged. Some supervisors might also say that they expect to see the leverage ratio rise as well. Such an action might induce too great of a countercyclical effect (and might turn a credit boom into a credit downturn). Also, a particular country's addition of a leverage ratio add-on would also have competitive-equity effects that are unintended.

2. Conversely, if supervisors in a particular country do NOT ask for a rise in the leverage ratio (concurrent with the required rise in Tier 1/RWA), then, in the example above, when the release period begins, the incurrence of losses will result in a decline in absolute capital, which may cause the leverage ratio to become binding, thus crippling the countercyclical effect of the release phase of the buffer.

Only if the leverage ratio were set low enough to be non-binding during both the build-up and release phases of the countercyclical capital buffer effort, would the buffer-then-release effort be successful (provided that the other problems discussed above and below have been solved).

I. Other issues.

1. The availability of data and the nature of data used to develop and maintain the buffer guide. Annex 2 of the Consultative Document indicates that depending on the country involved, the authors chose to use either a) data arising from a central bank's effort to track *liabilities* of borrowing firms and households; or b) data arising from a regulator's tracking of lending *assets* of a banking system. Clearly, the resulting measurements of credit may vary widely in terms of their actual indication of a possible excess of credit that might lead to banking sector difficulties in the future.

   For example, in the run-up to the current crisis, credit derivatives at regulated and non-regulated financial companies (including new forms of securitizations) were a primary cause of the crisis. Defining credit to be the liabilities of corporations and households would not adequately capture this explosion of credit-related risk exposures. Yet, the massive growth of the credit derivatives market does not translate naturally into a corresponding massive growth of the real economy. Thus, future attempts to measure credit/GDP ratios will be hampered by the size and growth of the credit derivative markets, which does not appear to have been statistically treated by the paper underlying the Consultative Document.

2. The multinational content of the proposal. The Consultative Document suggests that multinational banks having operations in several jurisdictions should have a buffer determined by the asset-weighted add-ons applicable in each country in which the bank operates. The basic problem with this part of the proposal is that, so far as we know, no supervisor is able is track how obligors in various countries use the proceeds from a particular bank loan. Thus, a multinational non-bank obligor headquartered in the U.S. may receive a loan from a U.S. bank and use the proceeds in China. The U.S. bank may or may not assess the credit risk of the loan with respect to the risk of the Chinese economy. But even if the U.S. bank does take this into consideration, the collection of such loan-proceeds-data by the regulator would be a nightmare. Thus, the Document's declaration that credit cycles are not always highly correlated across jurisdictions may imply that new data-gathering efforts are needed from bank customers, not just from banks. This would likely make the whole proposal untenable, without regard to any of the other issues above.

3. The future growth of the non-regulated financial sector. When taken in a broader context, the oft-mentioned major effect of the recent Basel III proposals is to drive some of the credit process away from the regulated bank sector toward the unregulated financial sector. Only a few of the Basel countries (perhaps none, other than the U.S.) have anticipated this by giving a central bank or bank regulator the tools to apply prudential supervision to certain non-banks. In the absence of such non-bank oversight, we can expect that the imposition of a capital buffer for banks will accelerate movement of the credit process to the non-banks, negating somewhat the macro-prudential intent of the buffer. Meanwhile, properly specified risk-based capital rules for the regulated sector will allow them to make only the least-risky of loans. Thus,

for the regulated sector, the buffer would not be needed, or at least not needed to the extent it would for the un-regulated sector.

4. Specific additional concerns regarding the academic work underlying the Consultative Document.

   a. While financial and real-sector cycles are broadly related, episodes of financial system distress are less frequent than business booms and busts. More importantly, the current crisis is perhaps the first such financial crisis that is truly global in nature. Therefore, the academic work, which is based on historical time-series data, may yield vastly different results in future time periods.

   b. The paper attempts to draw conclusions from the evidence on the 26 Basel countries as a group (even though the time series analysis was conducted separately for each country). Unfortunately, the recently expanded group of Basel Committee member countries now includes both emerging economies and leading economies, both managed economies and free-market economies. As indicated earlier, this means that the data-gathering effort regarding credit is vastly different across countries. [3] But also, there are different degrees of inflation and government intervention among these countries. Therefore, we don't see how any countercyclical buffer can be other than one imposed by an individual country (possible competitive-equity issues notwithstanding). Prescriptions from the Basel Committee should, at best, consist of guidance (as suggested by the tone of the Consultative Document) or, more simply, dissemination of continued Committee academic research.

[3] For example, for Argentina, credit is defined as central bank data on bank assets (loans to the private sector plus holdings of private-sector bonds by banks), plus IMF loans. For the U.S., credit is defined as obligor liabilities (Fed data on credit market debt outstanding for non-financial corporations, households, and non-profit organizations).

Appendix

RMA Capital Working Group institutions participating in the preparation and/or review of this response

Bank of America: John S. Walter, Senior Vice President, Risk Capital & Portfolio Analysis.
Bank of New York Mellon: Gary Gegick, Senior Vice President.
Capital One: Jonathan Horowitch, Vice President, Capital Management; James Weatherly, Managing Vice President.
HSBC North American Holdings: Mary Ann Hageman, First Vice President, Credit Risk Management.
JPMorganChase: Joseph P. Lyons, Vice President, Regulatory Policy; Michel Araten, Managing Director.
KeyCorp: Robert Kula, Executive Vice President; Tom Boltja, Senior Vice President - Director Economic Capital Management; Robert Levy, Vice President.
PNC Financial Services Group: Janis L. Tucker, Vice President.
State Street Corporation: William H Schomburg III, Senior Vice President, Director of Economic Capital.
SunTrust: James Stocker, Capital Manager, Treasury.
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