The Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

23 July 2010

Dear Sirs

Countercyclical Capital Buffer Proposal

Risk Reward Limited, the global risk advisory and training firm, are pleased to respond to this important paper.

Since we provide advice and guidance to financial institutions globally, we are able to consider the impact of these proposals on firms throughout the international financial market.

General Comments

We generally welcome the idea that capital should be counter cyclical, built up during periods of growth and then released during periods of stress. Taking this basic proposition we view the solution suggested as only partially achieving these objectives. We further consider the proposals to include a proposed level of complexity which will inhibit transparency.

We would recommend that two papers be produced – one for major international institutions and a separate one for the remainder of the industry. While the former paper may need to be technically demanding, we would expect the latter to remain principles based only directing local regulators to take a leading role in developing the appropriate regulations suitable for their local markets.

Specific Comments

Section 1 - Introduction

There is a statement here that capital is more expensive that other forms of funding. This is not true in all parts of the industry and many firms would not agree with this proposition, private banks for example. Indeed it is the failure to adequately consider all elements of the international market which we consider to be the greatest weakness of the paper.

The main idea is to build up additional capital when “excess aggregate credit growth is judged to be associated with a build-up of system-wide risk.” So rather than building up capital during the up-swing of the economic cycle, the proposals suggest capital being increased during periods of unnatural exuberance. We consider this to be illogical. The problem we envisage in practice is that while it is easy to identify such situations in arrears, it is hard to identify them in advance. Consequently delays are likely to occur which will undermine these worthy proposals.

Section 1 – Objective

By setting a “banking sector in aggregate” objective while setting objectives for individual firms, the regulations result in capital being too large in aggregate yet too small in individual cases. While we fully appreciate the issue being addressed it would still appear more appropriate for the buffer to be held centrally and provided to firms as required, rather than being distributed sub-optimally.

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Session 1 – Natural Buffer Decisions

The 12 month in advance rule highlights the problem identified earlier. The buffer would need to be predictive rather than historic to achieve its objectives, but the consequence of this could be to constrain economic activity earlier than would actually be required.

We also view the 12 month period for correction to be too long. Recognising the way that bubbles operate in practice under the application of these rules we would expect the build capital phase to have only commenced at the point of financial collapse rather than adequate capital being available.

Session 1 – Common Reference Guide

Our key concern here is the failure to take account of public sector credit and debt which clearly alters the international financial scenery. Given that different countries have different mixes of institutions both governmental and within the financial landscape, a failure to take account of this cannot be appropriate.

These proposals would result in a developing country that is moving towards international norms receiving inappropriate prejudicial treatment.

Section 2

Principle 1: Buffer decisions should be guided by the objectives to be achieved by the buffer, namely to protect the banking system against potential future losses when excess credit growth is associated with an increase in system-wide risk

We would broaden this principle to state “where an increase in the risk taken by the institution is inadequately supported by current capital calculations under plausible stress scenarios.”

Principle 2: The credit/GDP guide is a useful common reference point in taking buffer decisions. It does not need to play a dominant role in the information used by authorities to take and explain buffer decisions. Authorities should explain the information used, and how it is taken into account in formulating buffer decisions.

As we have stated above in many cases we do not believe this will be the appropriate measure to be used.

Principle 3: Assessments of the information contained in the credit/GDP guide and any other guides should be mindful of the behaviour of the factors that can lead them to give misleading signals.

Regardless of the basis adopted this principle is important and highlights an important concern. The level of transparency adopted could potentially be limited since disclosure of the increase is likely to result in the relevant financial institutions going under stress – actually causing exactly the situation that the paper is seeking to avoid.

Principle 4: Promptly releasing the buffer in times of stress can help to reduce the risk of the supply of credit being constrained by regulatory capital requirements.

We fully agree with this principle, but have sever doubts that regulators will in practice comply with these objectives.

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Principle 5: The buffer is an important instrument in a suite of macroprudential tools at the disposal of the authorities

We will need to see the final proposals to be able to judge whether that is the case. As currently drafted we would expect the values to be zero in most cases and therefore no impact would actually occur.

We do hope that you find these comments of interest and also look forward to seeing the revised proposals being issued in due course.

Yours sincerely

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