Santander

<u>Santander's Comments to the BCBS Consultative Document "Countercyclical capital buffer proposal"</u>

SANTANDER welcomes the proposal from the Basel Committee on Countercyclical Buffer. We acknowledge the harm that pro-cyclicality in the financial system can do to the real economy. Equally we recognise the need to ensure that the financial system plays a role in absorbing shocks, rather than amplifying them as has been the case to some extent during the recent crisis. We therefore support the goal of designing a macro-prudential approach that helps to identify and mitigate such pro-cyclicality.

However, it is necessary to bear in mind that pro-cyclicality in the financial system goes hand in hand with economic cycles and so a consistent policy approach that encompasses monetary, fiscal and macro-prudential policies is crucial when addressing this complex issue. This should mean that cooperation and coordination agreements are established that are much more effective than those currently in place, especially for cross-border banks.

Further, we would like to comment our full support to the generic provision system put in place by the bank of Spain since 2001. The latter has proven to be a useful tool to supply the system with a cushion to withstand the consequences of financial distress. We are not as certain of these benefits if a capital buffer system had been implemented instead.

Regarding the Basel Committee's proposal SANTANDER would like to make the following comments.

SANTANDER believes that the potential moderating effect of the buffers on the build-up phase of the credit cycle should be viewed as the primary aim of the BCBS proposal, rather than as a positive side benefit (as stated on p.3). The root cause of the problem is mispricing and excessive risk taking during a boom. The primary goal should be to introduce the right incentives in banks' credit policies in times of prosperity and growth. This will reduce the probability of systemic risk building up, rather than assuming systemic risk is building up and imposing buffers to reduce its damaging effects.

It is also worthwhile considering the different role that this tool could play in different geographical areas. For example, in countries where monetary policy is not a macro policy tool at national level (e.g. in the Euro area) we can expect the use of this mechanism to dampen pro-cyclicality will be required more often.

The geographic aspect also arises on the methodology proposed as it does not differentiate among the various levels of banking development in each country as commented on page 2 and more in detail in the annex

Finally, the calibration of this measure should take into account the cumulative and combined effect of the full set of measures countering pro-cyclicality and excessive risk taking. The introduction of this requirement on top of other measures (already decided upon) to mitigate pro-cyclicality could lead to a duplication of requirements that ultimately undermine efficiency and jeopardise sound and necessary credit growth. In particular regulators must take into account how the final proposals from accounting standard setters on forward looking provisions make credit less pro-cyclical. The effect of the amendments to the Basel framework to minimise possible pro-cyclical effects - e.g. by imposing downturn and through-the-cycle

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rating parameters and the planned capital conservation buffer as well as possible Pillar 2 buffers – should also be considered and should not lead to double counting. All these initiatives taken together will have a significant impact on pro-cyclicality.

From the point of view of the effectiveness of the proposal to achieve its intended goal we see the following weaknesses in its design:

1) **The proposal does not introduce the right incentives to reduce the excessive credit growth in booming times**.

The requirements do not discriminate between institutions that follow sound credit practices during boom times and those that follow too lenient ones taking advantage of the general over-enthusiasm. This will introduce perverse incentives in the system since institutions with more aggressive policies will experience increases in short term profits in boom times that will increase their capital basis without being relatively penalised compared with institutions with more conservative policies, thus reinforcing their riskier lending strategy.

2) **The proposal does not distinguish between credit types.**

It does not distinguish between types of credit. Therefore it will fail to identify asset bubbles before they become a more general problem and, more importantly, requirements could penalise sound credit practices (e.g. an over-extension of mortgages could lead to an excess of credit in the economy that implies higher requirements that does not only penalize mortgages but also other credit like for instance corporate loans). This criticism is similar to that levied at a rise in interest rates to remedy an over-extension of credit.

3) **It does not guarantee a level playing field.**

One of the main weaknesses of the proposal is the level playing field issues that arise from it. The proposed methodology is only a crude baseline that should be complemented by supervisory judgement to assess excessive credit growth. It seems improbable that this approach will lead to consistent assessments and the requirement for disclosure on the supervisory decisions may not be sufficient to counter this issue.

Moreover, it is not fully clear which authority should do the excessive credit growth assessment. As it is a macro-prudential issue it seems quite obvious that it is the authority in charge of macro-prudential oversight that should do the assessment. This authority could or could not be part of the same body responsible for micro-prudential supervisory issues. This could complicate even more cross-border coordination and convergence.

4) **It does not provide a sufficiently reliable methodology to identify excessive credit growth and turning points**

Admittedly, neither the Hodrick-Prescott filter (HPF) nor other alternatives analysed by the group seem to perform well enough to identify credit excesses where requirements must be tougher and turning points where the requirements are supposed to be relaxed.

Moreover, it should be taken into account that not all countries have databases with time series long enough and of sufficient quality to provide reliable estimations; therefore taking the

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HPF as a baseline could be an inadequate starting point especially for those countries that have experienced structural changes.

Finally, this methodology could unfairly penalise emerging countries where the banking system is still developing as it does not properly account for the catching up that is clearly visible in these countries.

The Annex includes more detailed comments on the main flaws we see in this methodology.

5) **It incentivises financing by (unregulated) entities outside the banking sector.**

The increase in the banking capital requirements will force banks to raise more capital thereby putting upward pressure on the cost of capital. This additional cost will be added to banks' lending rates, at least partially, creating incentives for more market based financing. This would just mean shifting the risk from a strictly regulated and supervised banking sector towards largely unregulated markets.

6) **It introduces uncertainty on the capital requirements and therefore on the return on capital.**

To the extent that the process allows for subjectivity in the supervisory assessments it will introduce uncertainty in the capital requirements and thus on the return on equity, making it more expensive to tap the markets successfully.

7) **Its implementation could be very burdensome.**

It could be very difficult, or almost impossible, to track all operations in order to identify the origin of each exposure (e.g. trading book, basket products, cross-border groups, etc). Requiring such identification will impose a significant burden on institutions, especially global institutions.

Proposed way forward

We think that the main areas where the proposal needs further work are:

1) The refinement of the baseline methodology in order to sort out the main drawbacks, especially avoiding penalising sound credit types, sound credit policies and credit growth in developing countries.

   We acknowledge how difficult the identification of asset bubbles could be but the cost of mistakes in detecting and reacting through specific higher exposure requirements should be held against the cost of allowing asset bubbles to turn into systemic ones, and the cost of undermining sound credit practices.

   We strongly support making the requirements risk sensitive by making them dependent on the actual counter-cyclicality of the bank's credit policy. A bank that is growing on sound foundations, and not on mis-pricing risk, should not be unduly penalised.

   Finally, we think that the baseline methodology should be amended to take into account the degree of banking development in a country (see Annex).

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2) There should be more detailed guidance on how to use the baseline methodology and how to fill the gap between the initial outcome from this methodology and the final outcome on which the requirements should be based.
3) Oversight of the process should be through international organisations (IMF/FSB) in order to make the assessments consistent.
4) Colleges of supervisors should play an important role in guaranteeing a consistent view on a cross-border group.

We are committed to provide further input in this process as we deem it important to get the right answer to a very complex issue and hope the Committee continues ready to discuss this issue in the coming months.

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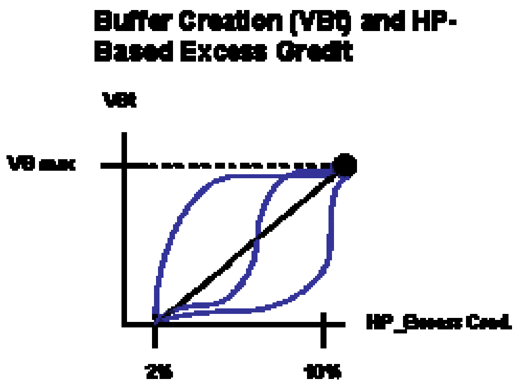
ANNEX: Methodological Issues.

SANTANDER finds that relying on a mechanistic proxy for excess credit growth such as Credit to GDP may lead to undesirable results. The reasons for this are as follows:

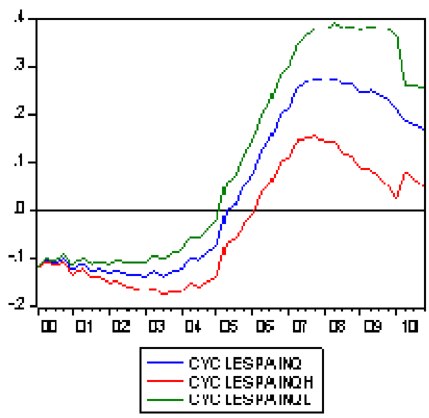
- A linear relationship between excess credit and the required buffer may not represent the optimal choice. Credit excesses appear in a non-linearly fashion that accelerates with the cost of capital, asset dynamics, agent expectations, etc. If a linear increasing buffer was implemented in a way that it would not match those periods of excess, then the entire rationale behind the measure would be questioned.



A linearly increasing buffer may not cover the excess credit if this increases in a non linear way. Here, different excesses are depicted in blue; note that if that was the way they were formed, the linear buffer (black) may not cover them when needed and / or cover unnecessarily when they are not.

- HP signals for excess credit (here measured as positive credit/GDP gap to the long run trend) are easy to manipulate. HP filtering requires introducing n-years ahead forecast of the variable subject to the filtering for the process to work (recall that it works as an expansion of series). For this reason the gap signaled today will be conditional on the forecasts introduced for credit and GDP growth. The figure attached shows the making of such *endpoint bias* on credit gap, meaning how different forecasts introduce different gaps.

Conditional HP cycles on credit/GDP forecasts.



In this chart one may appreciate the different HP credit gaps arising when different credit / GDP forecasts are used. Here the red line / blue / green depict different cycles when using increasing / stable / decreasing credit to gdp ratios.

- For the reason above, buffer and excess calculation entails a self determination problem (endogeneity) that has no trivial solution.

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- About the calibration of HP, we should recall that all lambdas used in Uhlig et al 2002 are calibrated for the US economy. Given that different economies have different credit cycles, a specific calibration for each country should be enforced.

- A further weakness of this measure could be that the HP criteria do not correct for the various starting conditions of each economy (banking development level, usually measured in credit to GDP). This would erroneously penalise retail banks in emerging, often under-banked markets that are still in a catching up process when compared to over-banked developed economies. For example, on average the credit to GDP in Latin America is barely 50% whereas in more developed economies the figure breaches 150%. Treating credit creation in both regions in the same manner would therefore be flawed.

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