Sent by e-mail to: baselcommittee@bis.org

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

10th September 2010

Dear Sir or Madam,

We are pleased to provide our response to the Basel Committee on Banking Supervision's ("BCBS") consultative document *"Countercyclical capital buffer proposal"* (BCBS 172).

Summary of our response

We recognise that excessive credit growth may give rise to a build-up of systemic risk and that macro-prudential oversight and tools should be developed to control credit growth and prevent excessive swings. However, we have serious concerns about the viability of the proposal in the consultative document to introduce a countercyclical capital buffer as a means of addressing procyclicality. We believe that the proposed buffer is too blunt a tool to achieve its intended objectives and there would be significant challenges in actually implementing it, so we are strongly opposed to its implementation.

In addition, we would like to stress the following points:

- A lack of capital in the banking system was not the cause of the financial crisis, so implementation of a countercyclical capital buffer would not in itself make the banking system safer.
- The countercyclical capital buffer will be seen by the market as part of the regulatory minimum, hence would actually make the capital framework more procyclical rather than acting as a lever to constrain excessive credit growth.
- The methodology proposed for deriving the countercyclical capital buffer appears rather academic and would be fraught with implementation issues. Furthermore, it is not clear how the buffer would operate in conjunction with the proposed changes to the capital and liquidity regimes (including other capital buffers which have not been fully developed such as the capital conservation buffer), existing tools and mechanisms used to address procyclicality and stress, and other macro-prudential tools.
- The increasing complexity of regulatory reform, including this proposal, threatens to obscure the real risks which banks and the economy are facing. There is a delicate balance to be achieved in enhancing the prudential framework whilst avoiding an overly complex regime that would inevitably result in an inconsistent implementation of the new requirements and an unlevel playing field.

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The proposed mechanism for applying the buffer, whilst appearing to have certain attractions as a theoretical construct, has been ill thought out and unlikely to work effectively in practice. The supervisory authorities in some of the markets in which we operate have expressed doubts about the practical implementation of the proposed buffer. We believe that the countercyclical capital buffer would be treated as a new regulatory minimum, therefore would not be available to absorb losses in times of need. Rather than implementing another buffer, there should be a renewed focus on enhancing Pillar 2 which already provides a suitable framework for addressing procyclicality and stress, but needs to be enhanced and properly implemented in an internationally consistent manner. We will set out our views on the proposal in more detail below and would welcome the opportunity to work with the Committee to help develop an appropriate framework for dealing with procyclicality.

How much of a problem is procyclicality?

We agree that there is a problem to address but it is important to note that it has not yet been possible to quantify the degree of cyclicality introduced by the Basel II Internal Ratings Based framework, as recognised in the BCBS 164 consultative document published in December 2009. Hence, the need for a countercyclical capital buffer is not proven and further research is required to get a clearer understanding of the extent to which procyclicality in the Pillar 1 minimum requirement is an issue and to identify the most effective macroprudential tools that could be deployed. Furthermore, further consideration needs to be given to how procyclicality should be addressed in those jurisdictions still operating under Basel I or where the implementation of Basel II has been restricted to the Standardised approach. Implementation of a buffer to fix an unknown risk will simply provide false hope that the issue has been addressed, rather than tackling the problem.

Enhancing the existing Pillar 2 framework

The existing regulatory framework already contains provisions under Pillar 2 that require banks to hold adequate capital buffers to withstand severe stress scenarios. The consultative document recognises that "…Pillar 2 will need to adapt to accommodate [the countercyclical capital] buffer, the capital conservation buffer and other proposed changes to the Basel capital adequacy framework", but it does not elaborate on how these will operate in practice. It is quite clear that there would be considerable double-counting between the existing and proposed new buffers, e.g. the capital planning buffer applied in the UK under Pillar 2 requires banks to hold a buffer above the regulatory minimum imposed on each firm by the Financial Services Authority (which in itself contains capital add-ons above the Pillar 1 minimum to reflect firm-specific risks), and this buffer is designed to ensure that banks maintain sufficient capital reserves to survive a severe stress including the impact of procyclicality. We would encourage the Basel Committee to develop a robust framework and explicit guidance to ensure that the various proposals are carefully intertwined and double-counting of capital requirements is not introduced. This should include enhancements to Pillar 2 to ensure that it is applied on a consistent basis internationally, including the implementation of capital planning buffers.

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Existing macro-prudential tools and development of new tools

The consultative document proposes the use of a countercyclical capital buffer as a macro-prudential tool without considering the effectiveness of macro-prudential provisions already in place in many jurisdictions. As an example, in Singapore and Hong Kong, the regulatory authorities apply to loan-to-value limits to restrict credit growth, targeting specific sectors of the economy that are overheating, and such a mechanism works well to dampen credit demand where required. Where these are seen to be operating effectively, then the need for a countercyclical capital buffer should be reduced or not required. In the case of an international banking group, the host authorities may believe that their existing approach to macro-prudential supervision precludes the need for an additional capital buffer, but the home authorities may take a different view without an adequate understanding of the local arrangements and impose a buffer for the exposures located in the host jurisdiction. It is therefore important for existing and future macro-prudential supervisory arrangements in the home and host jurisdictions to be considered before the imposition of a capital buffer. Close cooperation between and home and host authorities would be required in the setting of buffers for an international banking group.

There are a range of potential macro-prudential tools that could be utilised to control the build-up of systemic risk through excessive credit growth, including the implementation of forward-looking loss provisioning, introduction of mechanisms for varying the risk parameters used in the calculation of the Pillar 1 minimum capital requirements, and imposition of higher collateral requirements (such as loan-to-value limits on secured lending). It is important that all potential tools are carefully evaluated so that their individual and combined effectiveness are better understood.

The imposition of capital buffers across the entire banking industry, based on expectations about excessive credit growth, appears to be a rather blunt tool and would not address the shift of credit provision to the unregulated sector. There may be other unintended consequences such as the reduction of credit provision to creditworthy counterparties given that the countercyclical capital buffer proposal does not target the sectors of the economy that are overheating, and this would exacerbate the impact on economic growth. The consultative document notes that capital buffers could dampen demand by raising the cost of credit, although this could interfere with the role of monetary policy. We would therefore support the adoption of tools that target more directly areas of excessive credit growth and are more focused on specific sectors of the economy and take account of the different needs in emerging markets.

Capital buffer or a new capital minimum?

The capital conservation buffer is likely to be viewed by the market as part of the Pillar 1 regulatory minimum; hence banks would not be able to use such buffers in times of stress. It is certainly not possible to predict how the market will respond to the build-up and use of capital buffers, so banks' boards will inevitably treat the buffers as part of their regulatory capital minima. The same may apply to the countercyclical capital buffer unless there is a concerted effort to explain to all market participants the intention of the buffer and how it would operate in practice. Given the limited application of the countercyclical buffer during economic cycles, the embedding of the methodology will have to take place over a prolonged period.

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Utilisation of the capital conservation buffer is likely to be seen as a negative signal which will not only affect confidence in the banking sector, but also in the broader economy. Furthermore, the proposed advanced warning of the requirement for banks to build-up a countercyclical capital buffer 12 months prior to the expected downturn is also likely to send a negative signal to the market impacting confidence in the banking sector and the wider economy. The resulting rush to raise capital would have a destabilising effect on the banking industry, with the banks perceived to be the weakest particularly vulnerable. It is questionable whether the immediate use of the countercyclical buffer would help to maintain confidence in the banking system, and for an international bank, the use of the buffer will need to be agreed between home and host authorities which may take time to achieve or not be achieved at all. Measurable criteria would need to be defined in advance to determine when the buffer could be used.

Home-host concerns

The home-host aspects of the countercyclical capital proposal are likely to be problematic. The requirement for jurisdictional reciprocity is easy to apply in theory, but is likely to be much more difficult to achieve in practice. There is considerable judgement to be applied at a jurisdictional level and the chances of disagreement between home and host authorities is likely to be high (assuming that they share the conclusions of their judgements in the first place). It is completely inappropriate for home authorities to be making judgements on changes in economic and financial conditions in other jurisdictions, given that the home authority will not have access to the range of data and insights available to the host authority.

We are extremely concerned about the potential double-counting of buffers at local and group levels for internationally-active banks, as well as the scope for national authorities to use buffers as a political instrument by applying them inconsistently to domestic and foreign banks or to state-owned and private-owned banks. International oversight of the implementation and application of the countercyclical capital buffer would need to be undertaken by an appropriate body with suitable powers or influence to curb inappropriate practices.

The countercyclical capital buffer proposal, together with the increasing complexity of the reform package being developed, will make achievement of the desired international level playing field even more difficult to attain, leading to an increase in regulatory arbitrage. This could give rise to the introduction of other macro-prudential tools to control cross-border flows which would adversely impact international trade and investment.

Concerns with the credit-to-GDP guide

Use of this guide would be inappropriate for many jurisdictions, particularly developing markets, where long-term trends may not be wholly meaningful. Such markets are likely to require greater guidance from international authorities on the use of macro-prudential tools, but may be constrained by a lack of historical data and data that is available on a timely basis. Retrospective data revisions are often commonplace, clouding the signals that the data sends. The ability of national authorities to correctly predict significant changes in the economic cycle

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is generally unproven and the track record poor, including authorities in developed markets in the West. The risk of an incorrect call leading to the early build-up of countercyclical buffers would impede growth and could even have a destabilising effect on the economy.

The range of the credit-to-GDP ratios varies significantly from country to country. Economies that have less developed banking and monetary systems have low ratios that are also generally stable, whilst offshore centres and more developed markets are in a different league. The existence of a capital market, and its depth, is another factor as this will provide an alternative to bank finance for borrowers. In such cases, imbalances in the banking system and the wider economy may not be fully manifested through the credit-to-GDP ratio alone. Consideration needs to be given to how the ratio can most appropriately reflect maturing financial markets, recognising that when a significant new product is introduced, the credit-to-GDP ratio would increase substantially, just as it would do when a bubble is forming. It is therefore important to address these issues of reliability and viability if such ratios are to be used effectively in forecasting economic trends and be trusted by market participants and the wider public.

As the Basel Committee has rightly recognised, the credit / GDP gap "does not always work well in all jurisdictions at all times". For example, according to the data presented in the proposal, there appear to be multiple historical instances where (a) there was a banking crisis and countercyclical capital buffers would not have been maintained (e.g. Germany, Spain and Japan) and (b) there was no banking crisis and countercyclical capital buffers would have been maintained (e.g. Australia, Netherland and Sweden). However, a greater concern arises from the many cases where the lack of data presented precludes an evaluation of how countercyclical capital buffers would have performed (e.g. China, India, Russia, Saudi Arabia and Indonesia).

Practical challenges

International banking groups manage complex relationships, supporting the varied needs of their clients and customers across many jurisdictions. Credit facilities may be provided by banks in one location, but utilised in one or more other locations, and various tenors and currencies may be involved. It is important that clarity is provided on the scope of credit exposures that the buffer is intended to cover, e.g. short-term vs medium-term exposures. The buffer may prove to be an ineffective tool for jurisdictions that operate as an international financial centre. We see significant challenges in introducing the proposal in a synchronised fashion globally, especially as Basel II has not been implemented in all jurisdictions yet and where it has been implemented, the approach to Pillar 2 varies considerably. The consultative document recognises that some authorities may currently have little experience in publicly commenting on macro financial conditions and explaining future buffer decisions, and this will need to be addressed if the Basel Committee's intention that buffer decisions should be disclosed is to be achieved. Such complexities are not addressed by the proposal and need further consideration.

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Cumulative impact assessment

The complexity of the reform package being developed by the Basel Committee provides enormous challenges in assessing the cumulative impact of all of the changes on the global economy. We are concerned that the various buffer proposals have not been fully developed and the unintended consequences not identified. The consultative document recognises that “The transmission mechanism between required bank capital buffers and the impact on the price and demand for credit is not yet well understood.” It is therefore critical that the cumulative impact assessment is updated as the additional components of the reform package are developed and the overall package evolves to ensure that unintended consequences are identified and their impact minimised. Equally, the calibration of the new regulatory capital minima is an important consideration when determining the extent of any additional buffer required. The significant level of internal buffer commonly held across the industry, and which would continue to be held after the implementation of the new capital regime, should be recognised during the calibration work, as should the impact of banks treating the proposed buffer as part of the regulatory minimum.

Alternative to the countercyclical capital buffer proposal

We believe that it will not be possible to implement the proposal in an internationally consistent manner, particularly as the authorities in a number of jurisdictions have made clear their view that the setting of capital levels above the international regulatory minima set by the Basel Committee should be at the discretion of the national authorities.

Rather than calibrating and setting the minimum size of the countercyclical capital buffer, we believe that the Committee should enhance the existing Pillar 2 framework by developing more specific requirements for the setting of suitable capital planning buffers capable of withstanding severe stress scenarios including the impact of procyclical effects. This would have the advantage of building on an existing framework that has been in operation since 2007, rather than developing a new untested approach that overlaps with the existing approach, and would provide more time for evaluating the range of potential macro-prudential tools that could be used to improve stability.

Conclusion

The countercyclical capital buffer would not be an effective macro-prudential tool for controlling the build-up of excessive credit in the economy and implementing such a tool would be fraught with practical implementation challenges. A much more practical solution would be to enhance the existing Pillar 2 framework and ensure that it is properly implemented on an internationally consistent basis. The effectiveness of other potential macro-prudential tools, including tools already being used effectively in a number of jurisdictions such as loan-to-value limits, need to be evaluated further.

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We will continue to engage in what we trust is seen as constructive dialogue to improve the resilience and sustainability of the banking industry and to enable it to continue supporting the economic recovery and growth.

Yours faithfully,

Pam Walkden
Group Treasurer

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