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Basel Committee on Banking Supervision
Mr. Nout Wellink
Chairman
Centralbahnplatz 2
4002 Basel

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Consultative Document "Countercyclical Capital Buffer Proposal"

Dear Mr. Wellink,

We refer to the Consultative Document "Countercyclical capital buffer proposal" published in July and would like to thank the BCBS for inviting comments to this planned new measure that should complement the various far-reaching amendments to the regulatory framework of Basel II outlined originally in December 2009. Given their scope and potential impact, we strongly endorse the importance of an open consultative process.

1. Introduction

We agree with the finding that significant losses incurred in the banking sector during a downturn are often a consequence of a period of excessive credit growth. The ambition to introduce measures that aim at curbing such credit growth at a critical time before it has reached excessive levels seems to be convincing.

We already addressed the fundamental issues that are linked to such a proposal in our comment letter to the December 2009 proposals in April 2010. In particular, we expressed strong doubts that it was possible to identify a macro-economic variable that is sufficiently robust and credible to assess the extent to which there was a significant risk that credit had grown to excessive levels. We also questioned whether chosen variables would remain stable over time and show a useful correlation to events that led to systematic crises. Even if these concerns were proved to be exaggerated, a country-specific trigger and a uniform application of the countercyclical buffer to all institutions would be too simplistic a measure. Consequently we did not believe that a mechanical, statistical approach and elaborated models could provide a solution to this particular problem.

As we shall outline in our comment to the detailed buffer proposal below, we do not think that the proposed mechanism is able to alleviate these original concerns. Although the concept is based on a macro-economic model, it becomes rapidly clear that judgment will play a very significant role and in all likelihood be the dominant factor. One should not underestimate the potential ramifications of such an approach, for example, in terms of systemic risks, if all institutions in a country are required to act in unison or if regulators get the timing of their action wrong thus causing unintended negative consequences in their economy. Furthermore, the country-wide application of a buffer concept does not consider that excessive credit growth is often limited to a particular area and that a "one-size-fits-all"

application penalises institutions that pursue consistently more cautious lending practices even in times of rapid credit expansion.

2. Countercyclical Buffer in the Context of Other (Capital) Measures

The introduction of a countercyclical buffer comes at a time when the capital requirements for banks will be fundamentally overhauled. Parts of these revisions, together with some measures already implemented under Pillar 1 through A-IRB, already contain elements that should provide protection against the effects of downturn economic conditions. Such features are for example the calibration of rating models to PDs as they were observed at the highest level in a cycle, downturn LGD assumptions as well as stressed values for EPE and VaR. The emphasis placed on forward looking provisioning should also lead to stronger discipline in a rapidly growing credit environment. In addition to these measures practices and standards have been reviewed in many jurisdictions to reinforce the clear goal that a fall-out as severe as observed recently must not recur.

Overall, therefore, we believe that any need for another layer of capital – or buffer – should be carefully considered in the context of the entire regulatory framework including the changes that will be implemented in the near future.

3. Macro-economic Indicator

We appreciate the thorough investigation conducted by various parties in the industry, academia and within the BIS organisation, which supports the proposed credit/GDP ratio as the best indicator of emerging credit bubbles. However, we wish to point out that the general consensus from research is that even though the ratio appears to be the best among those investigated it is not necessary a good indicator. In this context we would note two observations. First, the level of credit/GDP that can be supported without causing extreme cyclical moves depends, inter alia, on the saving rate within a given economy. This has not been taken into account in the current proposal. Second, the volatility of credit/GDP may be very high, masking any trend in the indicator. This is particularly relevant when the GDP of a country has been rapidly changing from negative to positive with a subsequent downward correction.

According to the proposal the total amount of credit in a country should be considered without differentiation between its retail, corporate or asset based (mortgages on properties) components. As the history of the past decades has demonstrated in many instances, excessive growth of credit was confined to particular sectors without necessarily affecting other areas of the economy. Linking the capital buffer to the total volume of credit irrespective of the source of the bubble will unduly penalise large parts of a country's economy, by making credit more expensive, or individual banks, which are not active in the respective area of finance.

Also, regulators may set inappropriate incentives as banks which act more responsibly in times of rapid credit growth would be subject to the same penalty in terms of capital addition as those who behave less prudently. The lack of differentiation between firms is a severe drawback, as the degree to which financial institutions are affected by a market shock can vary substantially. This was also exemplified during the recent crisis.

More generally, the financial crisis, apart from providing "a vivid reminder that losses incurred in the banking sector can be extremely large when a downturn is preceded by a period of excess credit growth", has also demonstrated how wrong models can be in predicting the future. A weakness of the proposed model is that it is difficult to verify as application of hindsight and speculation about the outcome with regard to the solvency of banks might significantly cloud the result. Nevertheless, it would be helpful to get some examples of situations under what circumstances and at what point in time a

countercyclical buffer might have been introduced considering the circumstances of the past decade (and assuming that the buffer concept had been in place already at the turn of the century).

4. Role of Judgement

As the additional capital buffer is expected to be required on rare occasions only, and the model risks of using a single factor to determine the point when such action is needed are substantial, we severely doubt that – over time – lessons from applying the concept can be learned so that it may be refined and made more robust or objective. The countercyclical buffer is therefore likely to remain a theoretical concept for many years to come.

The necessary application of judgement will create new risks:

First, as bubbles in economies cannot be easily detected, especially when a turning point has been reached, or when their existence may be credibly questioned by some observers as a given situation may be due to an emerging new paradigm, the decision to apply a countercyclical buffer requirement will in most cases be a difficult one. If regulators act early in order not to cause capital levels to increase in the system when markets have reached a state of overheating, they may stifle growth also potentially provoke a political debate. So far regulation has been based on facts and observable data in addition to prudent oversight. The potential political ramifications of introducing measures into the regulatory framework that are highly judgemental should be carefully examined.

Second, needless to say that if the buffer is activated late in the process, the proactive build-up of additional capital may be illusory as many institutions might have to redress their balance sheets and call on the markets for additional capital at that time anyway.

5. Responsibilities

By introducing the new element, regulators would interfere with the capital management of individual institutions as their strategic and business plans have to be based on known and normally stable rules. As banks' Boards of Directors have to adapt their capital management plan by decree, and this may affect institutions which due to their business profile or lending policies would be less affected by the consequences of excessive credit growth, business models and bank stock valuations may be directly concerned. We view this intrusion into the responsibilities of the Boards of Directors as unprecedented and not desirable.

Also, supervisors would likely interfere with Central Bank's responsibilities as invoking the countercyclical buffer would de facto influence the cost of credit and monetary policies.

6. Economic Consequences

If the countercyclical capital buffer is applied for an amount which is not de minimis (and hence effective in the sense of the proposal), banks will have to adjust their capital base within a one year time horizon and for a limited period only. As the increase in minimum capital is based on RWA, it affects also existing business, which was written during more normal economic times. The likely reaction is therefore to rein in lending activities apart from potentially seeking new capital. Whilst this helps lowering growth and hence meets the goal of forcing banks to assess increasing risks carefully, the unintended consequences could be some form of credit crunch.

As we explained earlier, excessive credit growth may be observed in specific areas of an economy, normally in relation to asset values such as property prices. The application of a country-wide countercyclical buffer might therefore affect also sectors that are not related to the underlying causes of the market rally.

These observations support our view that there is a severe risk that politics might play an important role and public debates may precede the application of the countercyclical capital buffer.

7. Complexity of Implementation

There is a level of complexity in the implementation of a countercyclical buffer at country level, which has not been addressed in the document. We just highlight a few examples where we believe that the application of the concept is far from clear: Banks have among their counterparties globally active financial institutions and multinational companies, which may not have an important economic exposure to their country of domicile, or grant loans secured on assets where borrower and assets are domiciled in different countries. Operationally, banks would have to enhance their RWA ledgers with a country code relevant for the application of the countercyclical buffer and apply different minimum capital levels depending on the amount of the countercyclical buffer introduced by various jurisdictions. Based on such systems banks would then have to establish the level of capital and buffer they need for the assets and, separately, account for the countercyclical buffer for reporting purposes (transparency of the various layers of capital).

We believe that operational complexity and the likely relationship between cost and benefit have not been sufficiently addressed in the proposal.

8. Symmetry of Application

Whilst the creation of a countercyclical buffer will potentially be enforced early in the build up of a (perceived) credit bubble, we doubt that the status quo ante would be reinstated quickly once the fears of overheating have receded. Even if a release of the buffer were allowed by the regulator, it would be questionable whether banks would immediately react (e.g. by repurchasing shares) as there remain uncertainties about reinstatement and capital planning is a longer term process.

9. Alternatives

We believe that macro-economic assessments should be used by central banks and political authorities when defining their policy reactions aimed at stabilising the economy and countering signs of overheating.

Apart from standard policies of managing monetary expansion (interest rates, minimum reserve requirements etc.), concerns regarding excessive growth in certain areas of the economy could be targeted by specific means. For example, limitations of the value for which mortgages can be registered or assumed to be fully secured could be implemented in an environment where property price inflation is viewed as excessive – also on a sliding scale rather than abruptly – so that banks that exceed such limits would have to account for the differences as unsecured exposures with a commensurately higher LGD or even a minimum LGD set by regulators. Any such measures could be better targeted to the area of the economy which is causing concern and would be more transparent.

Furthermore, regulators should discuss banks' reactions to perceived imbalances in the economy within the framework of Pillar 2, which offers another lever for supervisors to exercise oversight over individual banks' positioning in the marketplace.

10. Conclusion

Despite the intellectual merits of a proposal to control the potentially higher risks banks take in times of substantial credit growth, we are of a view that the proposed approach cannot be meaningfully implemented and that other more traditional ways should be explored to control credit growth in specific areas. Therefore, we are not supportive of the proposal in its current form.

We thank you once again for the opportunity to comment on the proposal and are at your disposal to discuss any particular aspect of our response.

Yours sincerely

UBS AG

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