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

Dear Dr. Wellink,

Subject: Comments on the Consultative Document Countercyclical Capital Buffer Proposal

The World Bank welcomes the opportunity to comment on the *Countercyclical Capital Buffer Proposal* (hereafter "the Proposal") published in July 2010 for public consultation. As key providers of financial and technical assistance to low- and middle-income countries we have a strong interest in the ongoing global regulatory reform due to its potential effects on these countries' financial systems and thereby in their economic development.

The World Bank broadly supports the establishment of a countercyclical capital buffer that is based on internationally agreed methodology and will become part of the macro-prudential toolkit available to national authorities to promote financial stability in their jurisdictions. We welcome the development of a tool that is intended to be applicable in jurisdictions with different degrees of financial development. We consider these two characteristics of the tool – internationally agreed and highly adaptable– as key for its successful application across jurisdictions.

As this crisis has dramatically demonstrated once more, exuberant and unjustified credit growth rates tend to precede episodes of financial crisis. While many of our client countries have endured the crisis remarkably well, their national authorities are well aware of the importance of acting preemptively and having the necessary prudential measures ready for use before the situation deteriorates. Thus, from this perspective, we consider the Proposal a positive and important step forward in the right direction.

The World Bank agrees with the Committee on the need for further consideration of the home-host issues related to the buffer and its location. These are key questions for our client countries because many of them are host of large international banking groups. In our comment letter of April 14[1], we emphasized the importance of adequate allocation of capital within international banking groups to have better-managed institutions and more stable and efficient banking sectors. We also noted that while host authorities can legally require subsidiaries of foreign banks to hold adequate capital levels to support the risks taken in the host jurisdiction, in reality, some of them experience difficulties in calling for additional capital injections. For these reasons we highly

[1] See my letter of April 14 with WBG's comments on the Consultative Documents *Strengthening the Resilience of the Banking Sector* and *International Framework on Liquidity Risk Measurement, Standards and Monitoring*.

value the Committee's Proposal which clearly articulates the role and relevance of host authorities.

We appreciate the recognition, in the Proposal, of the need to allow the national authorities the discretion to decide on the relevant authority that may operate the buffer. While allowing this discretion, the Proposal rightly notes that decisions on the buffer will need to be taken based on an assessment of all relevant supervisory and macroeconomic information, which in turn will have implications for monetary and fiscal policies as well as banking supervision.

However, we have some reservations on the effectiveness of the Proposal in many low- and mid-income economies, as the selected indicator and the related rules may not adapt well to their specific circumstances. This points to the need for supplementing the proposed indicator with other indicators, such as credit growth. We also want to point out that some of our client countries have introduced countercyclical measures in their regulatory frameworks. These measures have been tailored to their conditions and may be effective in curbing systemic risk building in those jurisdictions. Therefore, the Proposal to make countercyclical capital buffer mandatory for these jurisdictions, when the private credit to GDP gap exceeds the prescribed threshold needs to be reconsidered.

Our comments below elaborate further on the World Bank's position on the above mentioned areas.

1. **Applicability and implications for low- and middle-income countries**

The World Bank considers that the Proposal has important implications for low- and mid-income countries, but finds varying degrees of applicability across jurisdictions. For example, the financial systems of low income countries are generally very shallow and a rapid increase in the ratio of private credit to GDP from a low initial base may be justified in some cases. In other cases, credit growth and GDP growth may both be volatile due to various factors, including lack of economic diversification and excessive exposure to external shocks. The application of the rule in these cases could result in erratic activations and de-activations of the buffer. Most middle income countries have higher ratios of financial depth and enjoy more stable conditions than those in low income countries, but these countries still have much lower ratios of private credit to GDP than the average ratio of developed countries. In these cases, the concern may be the opposite, namely, that the proposed rule would not curb systemic risk building resulting from excessive credit growth since the band that has been proposed is too wide (i.e. ranging from 2 to 10 percent of GDP).The proposed rule was designed taking into consideration the circumstances of Committee member countries and may prove effective and useful in these jurisdictions, but its application in low and middle income countries would merit a review. We thus kindly invite the Committee to further examine the behavior of the ratio of private credit to GDP and its deviations from trend in a representative sample of low and middle income countries and possibly consider enhancements to the proposed methodology. One option would entail the inclusion of other early indicators of systemic risk that are better adapted to the particular characteristics of low- and mid-income economies, and that would allow regulators to identify more effectively situations of excessive credit growth.

2. Interaction with existing countercyclical regimes

Some of our client countries have already put in place other types of countercyclical regimes, some of which have performed well during the crisis. These systems were designed to suit the specific characteristics of the banking sectors in which they are implemented. Therefore they are very different in their approach to refrain excesses – i.e. some adjust minimum capital requirements at different stages of economic and credit cycle, some impose more targeted measures (for example, countercyclical loan-to-value ratios on housing mortgages), and others establish countercyclical or dynamic provisioning requirements. We believe that the Proposal should not make it mandatory for the national authorities to replace the countercyclical measures that are already in place, that have proved their effectiveness during this crisis, with the proposed countercyclical capital buffer. They should have the discretion to deploy one or more countercyclical measures of their choice, when warranted.

3. Other specific comments and suggestions on approach and technical issues

The appendix to this letter notes our detailed and specific comments on both the approach and technical aspects of the Proposal. Our comments elaborate on the current incentives for risk build up outside the banking sector, and cover a range of issues related to the metrics and the processes that guide the timing and operation of the buffer. In each case, we have made some specific suggestions for the Committee's consideration, which we hope will be useful.

In summary, the World Bank welcomes the Committee's proposal, but would like to raise some significant issues both on the approach and technicalities for further consideration by the Committee in the finalizing process.

Should you have any questions about our comments, please do not hesitate to contact Martin Vazquez Suarez (mvazquezsuarez@worldbank.org) and Haocong Ren (hren@worldbank.org).

Sincerely,

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Appendix: Comments on the Technical Aspects of the Proposal

1. The common reference guide

a) Credit-to-GDP gap

While credit-to-GDP gap often is a good indicator for identifying cycles, the experience of our client countries shows that different patterns of credit expansion and cycles exist, which affects the effectiveness of the reference guide. Specifically, we find that while credit-to-GDP gap and the thresholds of 2% and 10% seem to perform reasonably well in member states of the Committee, they fail to identify in advance major episodes of financial stress in a number of our client countries for a variety of reasons.

1. For countries with low credit-to-GDP ratio, the proposed absolute thresholds may be too high because credit-to-GDP ratio will have deviated from the trend by a larger proportion relative to the trend before the buffer guide turns on and reaches its maximum, when compared to countries with much higher credit-to-GDP ratio (also mentioned in footnote 14 of the Proposal). This means that setting the thresholds for credit-to-GDP gap relative to its long-term trend rather than in absolute terms may be more robust given the differing initial conditions.

2. In some countries, high credit growth is offset by high nominal GDP growth (for example, driven by commodity booms) or is masked by a disproportionally high initial trend trajectory from a very low base. In these situations, the credit-to-GDP gap may not breach the threshold and the buffer may not be activated even though these countries might have a fast absolute credit growth which could lead to build-up of system-wide risk.

3. Credit expansion in different segments (such as real estate) may indicate build-up of risk in a certain area that may otherwise be masked by aggregate credit information. Experience in our client countries indicates that this indicator is very useful for identifying the build-up of system-wide risk.

4. Economic cycles are sometimes characterized by quick booms and busts driven by external shocks in some countries. These cannot be picked up by the proposed trend deviation based on long and smooth credit cycles.

5. Finally, GDP figures are reported with considerable time lags (more so in some developing countries than others) and are subject to multiple revisions. Considering that buffer decisions during the build-up phase will only take effect with a 12-month preannouncement period, using credit-to-GDP may result in a significantly backward-looking macro-prudential policy response.

All these reasons point to the need for supplementing the proposed guide by using other indicators, such as credit growth, based on country-specific situations. This would support the Committee's emphasis on the role of judgment in making buffer decisions. The World Bank welcomes the guided discretionary approach taken by the Committee and encourages it looking

further into ways of improving the applicability of its guide in countries at different level of development.

b) Definition of credit

The proposal defines credit as all sources of “debt funds” for the private sector, but it is unclear whether this includes credit to non-financial public enterprises. The credit series used for the empirical analysis (IFS line 32d) is calculated differently across countries, with some including credit to public enterprises and others not. Given that the amount of credit to non-financial public enterprises can be large in some of our client countries, we suggest the Committee clarify the definition to ensure inclusion of all relevant sources of credit are taken into account in evaluating risk buildup and making buffer decisions.

2. Implications on risk build-up outside of the banking sector

As currently proposed, the countercyclical capital buffer will be imposed on the banking sector only, which may place the banking sector in a position of competitive disadvantage and create incentives for risk build-up outside of the banking sector. To ensure the effectiveness of the proposed measures and limit its unintended consequences of distorted incentives, we suggest the Committee explicitly require national authorities to broaden the scope of the framework to cover non-bank financial sector to the extent possible or indicate how these concerns will be addressed by other building blocks of the regulatory reform agenda.

The Proposal suggests that the use of a broad definition for credit in the reference guide could mitigate some of the unintended consequences of providing incentives for banks to divert the credit supply to other parts of the financial system, but this only addresses the incentives of the banks (and only partly so because the consequences of an individual bank diverting credit through non-bank channels are shared by the entire banking sector). It ignores the impact of distorted incentives on other non-bank financing channels.

3. Type of capital that the buffer would be based on

The proposal notes that the countercyclical capital buffer would be based on Tier 1 capital to ensure that the buffer is able to absorb losses on a going concern basis, (similar to the capital conservation buffer proposal). The World Bank, however, thinks that the buffer should be based on common equity components of Tier 1 capital, which is more prudent given the purpose of the buffer.

As noted in the Proposal, the aim of the countercyclical buffer is to ensure the banking sector in aggregate can use the capital buffer to protect it against future potential losses when the broader financial system experiences stress after a period of excess credit growth. As we observed during the last crisis, common equity components are the first line of defense against such losses. Non-common equity Tier 1 instruments have serious limitations in absorbing losses on a going concern basis due to the inflexibility in coupon cancellation and inability of principal write-down. Given that the aim of the countercyclical buffer goes beyond ensuring the solvency of individual banks, one cannot assume that all going-concern capital is capable of achieving the goal of protecting the banking sector from losses to maintain flow of credit to the real economy.

We recognize that the Committee has put forward proposals to strengthen the loss absorbency of going concern capital by requiring fully discretionary dividend/coupon payments as well as principal loss absorption (through either conversion to common shares or a write-down

mechanism which allocates losses to the instrument at a pre-specified trigger point), which will mitigate our concerns to some extent. However, the final implementation and impact of the proposals remain to be seen, and grandfathering existing instruments likely will have long lasting effect on the loss absorbency of capital going forward. In this background, the Committee may like to specify the benefits of the buffer comprising of common equity.

4. Preannouncement period and average versus marginal capital requirements

We agree with the Committee that banks should be given reasonable time to bring capital levels up to the requirement during the build-up phase, but are concerned about possible delays. This is particularly important because reporting lags on some key indicators may already cause delays in the decision making process.

One alternative could be to keep the 12-month period as an upper bound and give national authorities the option of a phase in requirement on a shorter timeframe. In a similar vein, marginal capital requirements can be a useful alternative to average capital requirements during the grace period. This will allow the build-up of the buffer to commence immediately and help ensure the macro prudential goal of the proposed buffer.

5 . Capital conservation and treatment of surplus capital when the buffer is turned off

The capital conservation requirements imply that a bank will be required to retain a certain proportion of its earnings if it fails to meet the buffer requirement. We note that under this arrangement, the incentives for a bank to bring its capital level up to the requirement will vary depending on the jurisdiction the bank is operating in and the market pressure for distribution of earnings it is subject to. In some cases, this may cause delays in the build-up of buffers as some banks may only rely on retaining part of the earnings as required without actively seeking out other ways of raising capital. The Proposal allows the possibility of distribution in excess of the constraints by raising capital in the private sector to make up the difference. This renders the constraint ineffective and favors existing investors to the detriment of the prospective investor, and creates distorted incentives in capital-raising. We encourage the Committee to reconsider this issue in the finalization of the Proposal.

Finally, as is currently proposed, banks may distribute surplus capital when the buffer is turned off. As the release of the buffer kicks in immediately, but the potential losses are likely to manifest themselves with a lag, banks may not have the buffer when needed to absorb losses or maintain flow of credit as intended if the surplus is allowed to be distributed. Therefore, we suggest the Committee explicitly prohibit the distribution of surpluses arising from the release of the buffer.