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Comments by the Zentraler Kreditausschuss on the Basel Committee Consultative Document "Countercyclical capital buffer proposal"

Ref.: Basel

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As previously announced by the Basel Committee on Banking Supervision, the present Consultative Document seeks to provide a more detailed description of its proposals for a countercyclical capital buffer, outlined in its Consultative Document of December 2009 on "Strengthening the resilience of the banking sector". In our view, in some places the Consultative Document leaves major questions unanswered.

Before voicing our opinions on particular aspects of the present proposal, let us point out once again that we remain adamantly opposed to the "capital conservation buffer" likewise proposed by the Basel Committee. In our view, the envisaged restriction on distribution of earnings encroaches drastically on existing contractual agreements between banks and providers of capital, and we have considerable doubts about its legality. Moreover, the proposed "capital conservation buffer" is not designed to be a very effective tool for mitigating the cyclicality of the current rules. In particular, market players can hardly be expected to permit the dissolution of capital reserves during periods of recession.

Volume of the capital buffer and interaction with other measures

The Consultative Document does not offer any concrete details about the magnitude of the countercyclical buffer. However, the magnitude of the capital buffer is at least as significant, given that there is a close link between this and the proposed capital conservation buffer and the future definition of minimum capital requirements in general. Care needs to be taken, when ultimately setting the minimum capital requirements and add-ons, that risks are not being covered several times. The more use is made of add-ons to address cyclical risk and the risk deriving from periods of exceptional credit growth, the less need there will be to increase the minimum capital requirements.

May we also recall that the Basel reform package already contains a number of mechanisms designed, like the capital buffer approach, to help dampen cyclical effects. Examples are increasing the capital to support counterparty credit risk related to OTC derivatives and applying a leverage ratio.

It follows that the calibration of the countercyclical capital add-on must not be performed in isolation from other components in the Basel reform package. In this context, we would reiterate our request that the overall Basel III package be broken down into regulatory packages to be phased in step by step. These clusters should be implemented at intervals of at least a year. This would permit observation of the actual impacts and, where appropriate, steps could then be taken to eliminate any defects identified. Given that the proposed countercycli-

cal buffer is novel in its approach and that a number of aspects are still open, it should be deferred to a later stage.

Maintaining a level playing field with nationally defined capital add-ons

According to the proposal of the Basel Committee, the national supervisors should be provided the leeway to analyse phases in the economic cycle, to select the basic method for measuring credit growth and to set the capital buffer. To encourage the acceptance of supervisory decisions and avoid distortions of competition, we believe it is essential for all supervisory bodies to publish their decisions and to provide evidence that the indicators they have chosen are suitable detectors of system-wide risk. Moreover, if in any instance there is to be a departure from the preferred credit-to-GDP benchmark, the reasons for this should be stated. We ask for this aspect to be expressed more clearly in Principle 3.

Furthermore, there is a danger that having different capital add-ons in different jurisdictions could distort the competition between borrowers in different countries, given that rival companies may be obtaining finance under very different terms, depending on their home jurisdiction. The proposed introduction of a countercyclical capital buffer could, therefore, have major implications in terms of industrial policy. We invite the Committee to ensure that the countercyclical capital buffer is not exploited as a location incentive.

To prevent distortions to competition, we reject the proposed option for the home supervisor to require a higher capital add-on from banks within their jurisdiction granting loans in other countries than the host supervisor in these countries where the credit is provided. If the home supervisor were to impose higher add-ons on its banks when they operate in another country, these banks would incur higher costs of capital than their local competitors.

The Basel Committee's proposal may occur competitive distortions, because the home supervisor may independently require capital add-ons on loans which are granted in countries that do not specify and/or not publish the countercyclical capital charges (non-cooperating countries). The Basel Committee should define the measuring capital add-ons for non-cooperating countries in order to avoid competitive distortions.

Furthermore, we suggest that a review of the capital add-ons to be applied by individual countries will be published on the website of the Basel Committee.

Calculating bank-specific buffers

Definition of credit

The Basel Committee proposes a broad definition of credit, which will also include bonds, promissory notes and financing of other financial companies held by non-banks. However, it is not clear enough in the consultation proposal whether inter-bank transactions should be included in the definition of the credit or not. We ask for clarification in the final paper.

Calculation methodology

The Basel Committee expects the capital add-on to be based on deviations in the credit/GDP ratio from its long-term trend. If we have understood correctly, a capital buffer would have to be created once this ratio exceeded the trend by a certain amount. It is evident from the left-hand graph on page 25, which relates to the United Kingdom, that this could lead to a capital add-on being set even if the credit/GDP ratio was shrinking. It should be considered whether, rather than tracking the gap between the current ratio and the trend, the rates at which they are both rising should be compared: a buffer would then be created if credit/GDP was rising faster than the trend by a specific amount which still needs to be defined. If, on the other hand, the trend was rising faster than the ratio, the buffer could be returned to zero.

The trend of the credit/BIP ratio should be estimated by the national supervisory authorities. For the smoothing parameter Lambda the Basel Committee suggests a value of 400,000. Due to the different economic developments, however, different values for Lambda can be adequate in individual countries. We therefore ask the Basel Committee to set a range for Lambda. The estimation of the trend has influence on the needed deviation of the current credit/BIP ratio and therefore on the definition of the capital add-on.

Data availability

In order to calculate their bank-specific countercyclical buffer, banks require data about the geographical breakdown of their exposure. We estimate that banks should in general have the requisite data in their systems. However, calculating the buffer could prove very laborious for internationally active banks. We would therefore suggest applying a materiality threshold to keep the workload to a minimum when extremely small loans do not significantly affect the overall portfolio.

The proposed look through of structured products and also of investment funds will likewise generate a huge workload for banks that bears no relation to the benefits. We ask for this factor to be taken into account in an appropriate manner.

It is furthermore not clear to us, for example, whether in real estate finance the capital buffer is to be determined by the home jurisdiction of the borrower or of the property. Another question arises with regard to trade finance, namely whether the home country of the product vendor and of the product purchaser are of relevance. We would appreciate clarification on these points.

Publishing the jurisdictional buffers and the bank-specific buffers

The Basel Committee envisages that banks will have 12 months in which to build the pre-announced capital buffer. However, the process of capital planning for banks takes place over a much longer term than 12 months. This means that banks will not be able to include the countercyclical capital buffer in their regular capital planning. The setting of capital add-ons will, therefore, call for subsequent ad-hoc adjustments. In our view, a period of 12 months is too short, especially in a negative market climate, to acquire capital in the market under “normal” terms.

Treatment of surplus when buffer returns to zero

If the countercyclical buffer is turned off, the capital that has been released can be distributed. However, the Basel Committee envisages that a national supervisor will be able to prohibit this distribution if it feels that it would be imprudent in the light of the bank’s specific situation. Granting a supervisor this right to curtail distributions will further exacerbate re-capitalisation by the banking sector under already difficult circumstances. We therefore urge that this supervisory veto be repealed.

It is not clear from the Consultative Document when the countercyclical buffer can be used to absorb losses. A central decision by the national supervisor is critical in our view, because the principal deciding factor when drawing on a buffer will be the loan portfolio of a specific bank. By way of example, a bank whose portfolio consists largely of loans to suppliers will tend to be affected later in the cycle than a bank catering primarily for the service industry.