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10 September 2010

## **GFMA/ISDA response to BCBS 172: Countercyclical Capital Buffer Proposal**

Dear Sirs

The International Swaps and Derivatives Association (ISDA) and the Global Financial Markets Association (GFMA) are pleased to respond to the consultation BCBS 172 on Countercyclical Capital Buffers.

### **Introduction**

Our members recognise the need to ensure that firms are appropriately capitalised when moving into a downturn, and generally support the aim of removing **excessive** procyclicality from the Basel Capital Accord. Systemic risk is heightened when banks are forced to reduce their risk taking during periods of low or negative GDP growth and this provides another motivation. The industry further supports the development of banking reform proposals which are informed and transparent, and in that regard we think that a building block approach to organise the work on procyclicality is useful. However, we also have serious concerns regarding both the two proposed regulatory buffers, and their integration within the current and future prudential regulation framework. Furthermore, we foresee potentially significant problems with the operation and implementation of these regulatory buffers.

Our members urge the Committee to recognise the importance of fully understanding the consequences of the proposals, and of mitigating undesirable negative effects, before the proposals are implemented. In particular, we request that the Committee focus on finalising the Pillar 1 requirements before determining proposals in respect of the buffers. A significant period of reconsideration, trialling and further consultation is necessary before any implementation. The main issues that we perceive are as follows:

- **Level of cyclicity in the Pillar 1 requirements** - The extent of cyclicity introduced by the Basel II framework is not yet known owing to a paucity of

data. This framework has been available only since the end of 2006 and implementation dates have varied across jurisdictions. Given that the Basel framework is currently undergoing radical change, the implications, both in terms of the cyclicity of the new requirements and the impact on the wider economy, are even more difficult to determine. While we understand the political imperative for delivering a regime that addresses excessive procyclicality, we find it difficult to determine the appropriate level for any buffers until the Pillar 1 requirements are set and the implications of these new rules for cyclicity have been fully understood.

- **Macro-prudential tools** - The countercyclical buffer represents one of a range of macro-prudential tools. There is, to our understanding, little available research into the best mix of policy tools for addressing procyclicality. To determine the appropriateness of the countercyclical buffer proposal, it is vital for us to understand how this would fit into a wider package of macro-prudential tools both practically and quantitatively.
- **Potential for increasing systemic risk** - Market reaction to both buffer creation and release will be very important to the practical success of countercyclical buffers. While it is obviously too early to be able to determine reaction with certainty, the market response to the two buffers could prove counterproductive and possibly increase systemic risk. First, the Pillar 1 capital requirement plus the capital conservation buffer is likely to be viewed as a new minimum by the market, potentially from the point at which it is announced rather than at the point at which it is required to be held. Second, the signal that the countercyclical buffer is being initiated in a year's time could be a sell signal in relation to a particular jurisdiction, the firms within it, or firms exposed to it, making it harder for them to raise capital and liquidity. Third, it may also result in a rush for credit by customers before the buffer begins, especially those that hold undrawn facilities.
- **Role of the procyclical buffer and of Pillar 2** - We note that the consultation indicates that the buffer will not be a Pillar 2 tool. We are therefore not sure how it should be regarded; how it relates to Pillar 2; and how it will relate to the minimum capital requirements of Pillar 1. For example, in Pillar 2 firms are already required to consider the economic cycle in their ICAAP, and therefore we remain concerned about the possibility of buffers upon buffers. Moreover, we are concerned by the implication of this proposal for international consistency of application of Pillar 2. More fundamentally we would like clarity from the Committee on the future of Pillar 2.
- **Interaction with other countercyclical measures** - We would like to understand how the proposal for countercyclical buffers is intended to operate with the other measures that the Committee and the FSB have been considering to address procyclicality. For example, forward looking provisioning, which we support, is likely to reduce the need for a buffer by bringing forward recognition of losses and thus have a countercyclical effect by putting aside profits. In addition the extent to which firms' internal rating systems adopt a more Through the Cycle approach will also reduce the need for counter-cyclical buffers. Further, we would like to understand how the buffer interlinks with other measures already within the framework to address procyclicality such as

downturn parameters for IRB stressed VaR, and stress testing in the banking book.

- **Practical difficulties** - We also anticipate significant practical difficulties with the development of regulatory buffers. For example, the link between credit growth and the economic cycle is not well understood. The consultation indicates that a number of metrics will be used, in addition to the GDP to credit ratio, and that a significant amount of judgement will be required. This will mean that there is an elevated risk of inconsistency across jurisdictions and a lack of predictability for market participants, despite the disclosure of methodologies. We also observe that the proposal will raise potential home/host issues where determinations are different amongst regulators. Thorough testing of approaches should be undertaken before requirements are imposed on firms.
- **Release of the procyclical buffer** – As noted above, the potential for the new buffers to be perceived as a new minimum is of concern. Currently it is unclear as to when and how the buffer can be released, and how the market will view such a release. Further clarity on this point may serve to allay some of our concerns in relation to the buffer being perceived as a new minimum, a perception which might make it difficult for supervisors to release the buffer.

While the consultation is not asking for further comment on the capital conservation buffer, we do not believe that it is possible to consider one buffer without the other, as they are inextricably linked. Although the banding approach to the conservation buffer was articulated in the December 2009 package, it appeared to be a less well developed aspect of the proposal. As such, members commented on it only in more general terms as they were expecting these two elements to be considered further. We would therefore like to reiterate our earlier points in relation to the capital conservation buffers, and, in particular, the potential for multiple application of buffer requirements, given existing tools available to supervisors.

## **1. Overarching issues in relation to the regulatory buffers**

### **1.1. Interaction between the proposed regulatory buffers and other regulatory requirements**

As a result of Basel 3 and other regulatory changes, banks will face substantial increases in capital and liquidity requirements and, as part of the ICAAP process, they will need to demonstrate resiliency following stress tests. We urge the Committee to evaluate how the addition of capital buffers integrates with these other changes.<sup>1</sup>

As the consultation indicates that the buffer is not a Pillar 2 tool, it is not clear how it should be treated and how it relates to the Pillar 1 requirement, which is supported by total capital.

Pillar 2 already provides supervisors with many of the tools that underpin both the buffers proposed, for example preventing dividend distribution and

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<sup>1</sup> For example, a stress test should contemplate a severe cyclical downturn, possibly as a result of excess credit growth, and consider whether firms have sufficient capital to meet these circumstances; this would meet the same objective of the countercyclical capital buffer.

requiring firms to maintain capital buffers to reflect their risks. During the crisis these tools were deployed effectively. There is therefore a very real risk of duplication of coverage. In our view, Pillar 2 is a vital part of the regulatory framework that allows for differing business models and structures to be addressed. Where Pillar 2 tools are used effectively and consistently, the need for additional buffers is highly questionable. We continue to believe that, where possible, existing regulatory tools should be used before new approaches (of necessarily questionable efficacy) are developed. Thus we suggest that the consistent application of Pillar 2 should be a focus of the Basel Committee through its Standards Implementation Group.

### **1.2. New minimum requirement**

An issue with both the capital conservation and counter-cyclical buffers is that they will be perceived as a new minimum requirement. Although we note the Committee's intent of allowing both regulatory buffers to be run down and absorb losses in periods of stress, we are concerned about firms' ability to use the countercyclical buffer, given the requirement to disclose these activities to the market.

### **1.3. Calibration and impact**

If the Committee pursues the model proposed, it will be vital that the calibration of the appropriate range for each of the regulatory buffers be considered incrementally alongside the exercise to recalibrate the capital framework. This exercise should include both the review of existing national buffer processes to align processes and the elimination of double counting. It should also take account of the wider consequences for lending capacity and the real economy, as well as the impact that restrictions on the payment of dividends might have on the attractiveness to the market of an institutions' common equity or other securities. Full consideration would also need to be given to appropriate implementation and transition provisions, including further industry consultation. We note that, neither this consultation, the Basel Group of Governors and Heads of Supervision press release of 26<sup>th</sup> July 2010 (on the countercyclical capital buffer add on), or the December package's capital conservation section specify calibrated ranges. We further note that a 2% example for the capital conservation buffer was cited in the December package purely for illustrative purposes. Given the Committee's intention to finalise the two proposals jointly, our members' views may be greatly influenced by a result which is as high as, or higher than, the illustrative example for either regulatory buffer. The industry requests further dialogue as part of this calibration process.

## **2. The countercyclical buffer**

Our members support the aim of addressing excess procyclicality and of ensuring the banking system is adequately capitalised to face the consequences of periods of excess credit growth. However we wish to draw the Committee's attention to the following considerations:

## **2.1. Cyclical<sup>2</sup> of the regulatory capital requirements**

As noted in the December consultation, the extent of cyclical<sup>2</sup> in the Basel II framework is as yet unclear. Prior to the revisions that are currently in train, there are only limited data points available as the framework has only been in operation since the end of 2006. The European Commission's recent report to the Council and the European Parliament 'On the effects of Directive/EC and 2006/49/EC on the economic cycle' also indicates that there are currently insufficient data to determine definitively the cyclical<sup>2</sup> of the framework and the causes of volatility experienced to date, and that further monitoring would be necessary. As a result, and given the significance of the changes currently underway, we think that determining the appropriateness of countercyclical buffers will be an extremely difficult task. We further think that it is important that the Committee consider the full implications of the changes underway and the timing of introduction of any such measures.

The current changes to the requirements are also likely to change the reaction function of firms. Assessments made on data available to date on how firms react as credit conditions change may not be reflective of how firms will behave in the future, especially if they are subject to different incentives. While forecasting such behavioural changes is not without difficulty, it is important that such factors are taken into consideration in the development of this proposal.

## **2.2. Practical implications of the counter-cyclical buffer**

We note that the Committee believes that a perceived side effect of the proposal will be to limit excessive credit growth. While we recognise that this is not a primary objective, and agree that it should not be, we also believe that the proposal will be limited in its ability to deliver this benefit because:

- There are no corresponding considerations of mechanisms to restrict a growth in *demand* for credit and how this may be managed.
- Further, changes in the supply of credit may well come from non-bank sources, something that these proposals do nothing to moderate.
- Monitoring aggregate credit/GDP would not allow regulators or national authorities to address credit growth in a specific type of lending unless this causes the total ratio to increase markedly<sup>2</sup>.

We also note that there are some practical problems with the proposal even as a measure for address procyclicality:

- The link between credit growth and the economic cycle is not clear. This is likely to be a particular issue for emerging economies, where credit growth is likely to be strong as economic recovery takes hold.

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<sup>2</sup> We note that Barrell, et al in their paper on Calibrating Micro-prudential Policy suggested that other variables - particularly residential real estate prices - are better predictors of asset price bubbles than credit to GDP. They further emphasised that it is poor quality lending that is the primary cause of crises. It is therefore recommended that the use of a risk adjusted credit measure to GDP may be more reflective of excess credit growth rather the use of nominal credit measures.

- When applied at the level of individual firms, the risk of credit growth is likely to be very different depending on the business model being pursued. However the proposal, thanks to its jurisdictional application will treat conservative business models the same as much more aggressive ones.
- Judgment is at the heart of the Committee’s proposals, yet the history of prudential authorities in identifying bubbles is at best mixed. The use of judgement will also potentially lead to inconsistency of application across jurisdictions.

Statistical measures can be backtested, but the impact of employing a related capital buffer is impossible to determine as market reactions to these constraints are unknown. This suggests caution. Moreover, the Committee should evaluate how the use of the proposed measures, and the subsequent changes in capital requirements, would interact with the employment of other macro-prudential tools, and with monetary and fiscal policy, as these also have an important bearing on credit growth.

It is important to note that some procyclicality is inevitable, and indeed desirable. Firms should base their risk decisions on current conditions. The purpose of any regulatory invention should therefore be to manage *excessive* procyclicality, not to attempt to remove it from the financial system entirely. The most important tool here is the credit granting process, as lax credit provision (whether by banks or non-banks) is a key enabler of asset price bubbles. We note here that extensive requirements already exist in Basel 2 concerning the credit extension process, the appropriateness of internal rating for the risk of the exposure, and related issues. These requirements, if uniformly implemented, already provide a powerful tool for the management of credit growth.

### ***2.3. Unclear interaction between the set of proposals to reduce procyclicality***

The Committee addresses procyclicality with a number of overlapping proposals, the cumulative and incremental impacts of which need to be understood. Once this has been achieved, the proposals should be refined to address their limitations before any consideration of implementation.

The consultation document identified the following four factors to “reduce procyclicality and promote countercyclical buffers” yet the proposal deals only with the last and is unclear how it would interact, if at all, with the other factors:

- 1 Dampen cyclicity of minimum requirements (primarily through the use of through the cycle PDs or downturn PDs)
- 2 Promote expected loss provisioning
- 3 Conserve capital (fixed buffer)
- 4 Protect banking sector from period of excess credit growth

This omission becomes even more serious when the other measures not discussed are considered. For instance, monetary policy (including not just the setting of rates, but also the range of eligible collateral in central bank open market operations, the duration of operations, and their size) has important

cyclical effects. So too does the regulation of non-bank credit channels, an increasingly important form of credit provision.

The discussion of other proposals to reduce procyclicality also suggests a related issue, namely the right mechanism for reducing any perceived excessive procyclicality. In theory, interventions are possible on both the asset and liability sides, and on the liability side at various points in the capital structure. Capital is not the only tool here. Thus for instance, as we discuss elsewhere, provisioning policy – an intervention at the level of expected loss – may be a more efficient tool than the imposition of extra capital requirements. Before imposing extra capital, the Committee should be confident that this is the most effective intervention, and that it does not have undesirable side effects.

#### ***2.4. Market and industry reaction***

Potential consequences of introduction or release of the buffer include:

- 1 Banks may already have in their pipeline of approved credits and commitments expansion of credit which cannot be easily turned off. Customers may rush to draw down their credit lines in expectation of tightening credit conditions and increased costs, thereby creating the very conditions that the Committee is hoping to avoid as a ‘side effect’ of the proposal. Alternatively borrowers may seek credit outside the regulated banking sector to eliminate their risk of reduced funding.
- 2 Markets may react negatively to the imposition of a buffer, particularly if the basis of determination is unclear and the buffer is unexpected. The decision may be perceived as a sell signal for that jurisdiction or banking sector, thereby creating systemic risk.
- 3 Markets, and particularly rating agencies, may perceive the increased buffer as being required immediately, regardless of the proposed lead time, causing many banks to rush to market and cause a log jam.
- 4 The release of the buffer may also be perceived as a sell signal on a particular market thereby increasing systemic risk.

Clarity over the purpose of the countercyclical buffer, how its size is determined, and regulatory expectations with regard to its release and use will be vital to ensure that negative reactions are minimised. We also note that the buffer decision may create further tension with accounting standards and disclosures.

#### ***2.5. Macro-prudential supervision***

Macro-prudential supervision is still in its infancy and little has so far been published on how it might be achieved. Obviously the countercyclical buffer is one such tool that could be used. The Committee has indicated that the countercyclical buffer is only likely to be needed very infrequently, but the need for its application will also depend on the other tools that could be used. Therefore it is difficult for us to comment on it meaningfully without understanding how it fits in the context of the toolbox as a whole.

## ***2.6. Application issues for the countercyclical buffer***

### **2.6.1. Home/host considerations**

The proposal is likely to raise some significant home/host issues that will need to be resolved. For example, a home country regulator could declare that a higher buffer is required in a host country, but if the host country regulator disagreed, the impact would be binding only on firms primarily supervised in the home country and not on the firms supervised in the host country. Approaches need to be developed to forestall competitive imbalances.

### **2.6.2. Location of the buffer**

We are concerned about the potential for duplication of the buffer in terms of where it will be required to be held. While the Basel framework is usually applied at the consolidated level, we note that host regulators are entitled to require the buffer to be held in the local entity. However, while it clearly indicates that home regulators must ensure that a buffer is held at the consolidated level if the host decides not to exercise this right, the converse, i.e. that there should not be a duplicate buffer held at the consolidated level where one is held in the local entity, is not clearly articulated.

### **2.6.3. International consistency of determination of buffer**

The proposal indicates that where a jurisdiction does not operate and publish buffers, home authorities will be free to determine their own buffer add-ons. As buffer determinations will inevitably involve a degree of judgement this could result in different buffers for the same jurisdiction depending on different home state views. This could cause competitive distortions. It will be vital that there is international comparison and exchanges of views to ensure that a common position is reached on these jurisdictions.

The application of excess growth to emerging market countries may need to be given particular attention, given likely strong credit growth in the coming years, so as not to provide a serious detriment to their development.

### **2.6.4. Determination of exposure**

We note that the consultation indicates that the buffer will reflect the geographic composition of the bank's portfolio of credit exposures. Does this mean that the determination will be made in relation to the firm's banking book regulatory balance sheet rather than the statutory balance sheet?



#### **2.6.5. Determination of location**

There are also a number of issues that will need to be addressed in ensuring consistent determination of location of exposure. For example:

1. While banks can report exposures by country of domicile, for many multinationals, banks make credit available at multiple locations for that multinational's operations. We would recommend the Committee consider further how banks will confirm the jurisdiction of counterparty: will this be on the basis of head office location, legal entity or something else?
2. Multinationals could themselves re-resource credit from one subsidiary to another if lending in one country was deemed curtailed because of its excess growth determination.

#### **2.6.6. Release of the buffer**

The consultation is less clear on the mechanisms for release and use of the buffer. This is vital if the proposal is to deliver the outcome intended. In addition clarity is needed to inform market expectations, to minimise the risk that the buffer will be perceived as a new minimum requirement.

#### **2.6.7. Disclosure of the countercyclical buffer requirements**

Clear and timely disclosure will be imperative if the buffer proposal is to be effective and we think it will take a period of adjustment before co-ordinated disclosures can be created. We support the concept of a website that collates buffer decisions, but we are curious as to why the Committee has rejected the idea of quarterly statements. We believe that quarterly updates would be very helpful to market participants, although accepting that significant changes may mean that additional disclosures are necessary.

#### **2.6.8. The capital conservation buffer**

The Basel December 2009 Consultation document included a proposal for a capital consultation buffer to address the third objective to conserve capital to be used in times of stress. We do not support the introduction of a capital conservation buffer and in our joint trade association response to this consultation we raised the following concerns in relation to a capital conservation buffer and the broad concept of a countercyclical buffer. If the Committee's intention is to integrate both these regulatory buffers it is important to reflect on these points:

- Where jurisdictions already operate equivalent measures to those proposed, and which are proven techniques, we would urge the Committee to align its proposals with existing supervisory

practice, rather than introduce new duplicative or inconsistent requirements which we would not support.

- We also suggest that where firms already have a substantial buffer and are seen to be well run with adequate systems and controls, this should be taken into account rather than requiring a further buffer.
- We also believe that our concerns about market reaction and the buffer being perceived as a new minimum equally apply to the capital conservation buffer.

### **3. Conclusion**

As a result of our discussions, outlined above we have the following recommendations:

#### ***3.1. Alternatives to the regulatory buffers***

We continue to believe that, where possible, existing regulatory tools should be used to avoid unnecessary regulatory duplication or double counting. Pillar 2 already gives supervisors such tools, such as preventing dividend distribution and requiring firms to maintain capital buffers to reflect their risks. The tools to conserve capital already exist within Pillar 2 and therefore the consistent application of Pillar 2 should be a focus of the Basel Committee through its Standards Implementation Group.

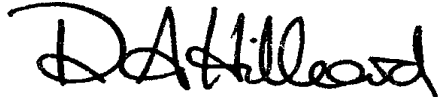
#### ***3.2. Further review***

The Committee addresses procyclicality with a number of overlapping proposals, the cumulative and incremental impacts of which need to be understood. Once this is done, the proposals should be calibrated and refined to address their limitations before any consideration of implementation. We must be cautious with a new macro economic tool, especially as we cannot be certain how this will interact with the real economy. More research on the efficacy of this tool is required before final determination of approach.

Given the untried nature of the elements of the proposal, the implementation issues raised, and its relationship to other minimum requirements and their calibration, the Committee is urged to proceed with caution, if at all. We note the press speculation around the Committee's meeting on 7<sup>th</sup> September and are concerned that determination of the size of the counter-cyclical buffer would be premature at this point in time. Further testing of the approach, taking account of the other changes in capital and liquidity requirements, should be undertaken before finalising the proposal. This will allow the supervisory community, central bankers, and the banking industry to determine how best to design and implement these measures to ensure that firms are appropriately capitalised when credit conditions turn for the worse.

We hope that you find our contribution helpful and we would be very happy to discuss any aspect of the response with you.

Yours sincerely



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