Countercyclical Capital Buffers (Limiting Procyclicality)

*The Countercyclical capital buffer (‘CCB’) aims to achieve the broader macro-prudential goal of protecting the banking sector from periods of excess aggregate credit growth that have often been associated with the build-up of system-wide risk.*

*In addressing this primary aim, the CCB regime may also help to lean against the build-up phase of the cycle in the first place, by raising the cost of credit and thus dampening its demand.*

*Jurisdictions will be required to monitor credit growth in relation to measures such as GDP and assess whether growth is excessive and leading to the build-up of system-wide risk. Based on this assessment a CCB requirement, ranging from 0 to 2.5% of risk-weighted assets, may be put in place.*

1. **Why it Matters**

1.1 Pro-cyclicality (amplification of the effects of the business cycle) in banking was said to have helped exacerbate the impact of banking crisis, and whilst it is inherent and cannot be eliminated, the countercyclical capital buffer aims to reduce its amplification through the banking sector, in particular that caused by excessive credit growth.

1.2 The Basel Committee on Banking Supervision (BCBS) sees the CCB as resulting in the following benefits:

   i) Protecting the banking sector from losses resulting from periods of excess credit growth followed by periods of stress;

   ii) Helping ensure credit remains available during periods of stress;

   iii) During the build-up phase, as credit is being granted at a rapid pace, it may cause the cost of credit to increase, acting as a brake on bank lending.

1.3 The common reference point put forward by the BCBS for taking CCB decisions is the credit-to-GDP guide. It is important to note that the BCBS has caveats with respect to its use, not least that the common reference point could give misleading signals if used as a standalone measure.

1.4 As a result, the BCBS propose supervisory judgment is also exercised when CCB decisions are made. The key role given to judgment by relevant national authorities, the designation of which will be left to each jurisdiction, could however result in an unlevel playing field.

1.5 It is also important that the CCB is seen and used not in isolation but with regards to the full potential suite of macro-prudential tools.
2. Summary of AFME Position

2.1 The countercyclical buffer is one of a range of prudential initiatives designed to limit pro-cyclicality and, whilst AFME supports the principle of a less pro-cyclical framework, we do have a number of significant concerns relating to its operation and its interaction with other counter-cyclical measures and the wider Basel III and prudential framework.

2.2 We suggest a Pillar 2 approach, so that a more tailored regulatory response can take place, with supervisory colleges assisting with consistency of implementation.

2.3 Failing that, a simplified version would help reduce the need for costly systems enhancements. This could be based on banking book exposures only and in particular should take account of bank’s existing country risk methodologies.

3. Regulatory Context

3.1 Since the beginning of the financial crisis pro-cyclicality was regarded by the G-20 as a key issue to be addressed. The financial crisis has illustrated its disruptive effects and there was broad consensus that there is a role for prudential instruments to smooth the effects of the credit cycle. The BCBS’s rationale for the introduction of a countercyclical capital buffer as part of the Basel III package focused on the need for the banking sector to build up its capital defences in periods when credit has grown to excessive levels.

4. Overview of the Countercyclical Capital Buffer

a. General Points

4.1 Countercyclical buffer requirement will vary between zero and 2.5% of risk weighted assets, depending on the judgment of individual jurisdictions as to the extent of the build-up of system-wide risk in a given jurisdiction. However, whilst the international reciprocity provisions set out in Basel III set the maximum countercyclical buffer as 2.5%, national authorities can implement a buffer in excess of 2.5% for banks in their jurisdiction, if deemed appropriate. The CCB requirement will be released when system-wide risk crystallises or dissipates.

4.2 The decision to raise the level of the CCB will be pre-announced by up to 12 months. Decisions to decrease the CCB level will take effect immediately. Both pre-announced and actual buffers in place will be made public.

4.3 The CCB is articulated as an extension of a bank’s capital conservation buffer, and banks will be subject to restrictions on distributions if they do not meet the requirement.

4.4 Banks will be required to calculate and publicly disclose their CCB requirements with at least the same frequency as their minimum capital requirements. In addition to disclosing their CCB requirements, banks will also have to disclose the geographic breakdown of their private sector credit exposures used in the calculation of the CCB requirement.
b National Countercyclical Buffer Requirements

4.5 Each jurisdiction will identify an authority with the responsibility to make decisions on the size of the CCB and its implementation / release.

4.6 Relevant national authorities will monitor credit growth and other indicators that may signal a build-up of system-wide risk and make assessments of whether credit growth is excessive and is leading to the build-up of system-wide risk. Based on this assessment they will put in place a CCB requirement.

4.7 BCBS issued ‘Guidance for national authorities operating the countercyclical buffer’, which outlines the principles that relevant national authorities have agreed to follow in making CCB decisions.

4.8 To assist the relevant national banking regulators in each jurisdiction in making buffer decisions, the BCBS has outline in its Guidance document a methodology to serve as a common starting reference point. The methodology “transforms the aggregate private sector credit/GDP gap into a suggested buffer add-on”, with a zero guide add-on when credit/GDP is near or below its long-term trend and a positive guide add-on when credit/GDP exceeds its long term trend by an amount which suggests there could be excess credit growth.

4.9 BCBS does not however intend for the jurisdictions to rely mechanistically on the common reference guide, but rather for them to apply judgment in setting of the buffer after using all the available information. The use of judgment needs to be firmly anchored to a set of principles also outlined in the Guidance:

- **Principle 1**: (Objectives): Buffer decisions should be guided by the objectives to be achieved by the buffer

- **Principle 2**: (Common reference guide): The credit/GDP guide is a useful common reference point in taking buffer decisions but does not need to play a dominant role in the information used by authorities to take and explain buffer decisions

- **Principle 3**: (Risk of misleading signals): Assessments of the information contained in the credit/GDP guide and any other guides should be mindful of the behaviour of the factors that can lead them to give misleading signals

- **Principle 4**: (Prompt release) Promptly releasing the buffer in times of stress can help to reduce the risk of the supply of credit being constrained by regulatory capital requirements

- **Principle 5**: (Other macroprudential tools): The buffer is an important instrument in a suite of macro-prudential tools at the disposal of the authorities
4.10 In terms of jurisdictional responsibility for the CCB requirement (for internationally active banks), the powers / responsibilities of home and host relevant authorities will be divided as follows:

- **Home authority:** ensure that the banks they supervise correctly calculate their buffer requirements based on the geographic location of their exposures; set their own buffer add-ons for exposures to jurisdictions that do not operate and publish buffer add-ons; require that the banks they supervise maintain higher buffers if they judge the host authorities’ buffer to be insufficient

- **Host authority:** lead in setting buffer requirement that would apply to credit exposures held by local entities located in their jurisdiction; have the right to demand that the CCB be held at the individual legal entity level or consolidated level within their jurisdiction

c **Bank Specific Countercyclical Buffer Requirements**

4.11 Banks will be subject to a CCB between zero and 2.5% of total risk weighted assets, to be applied at the consolidated level. However, national supervisors may apply the CCB regime at the solo level to conserve resources in specific parts of the group. The CCB will need to be met with Common Equity Tier 1 or other fully loss absorbing capital (currently under review).

4.12 The buffer that will apply to each bank will reflect the geographic composition of its portfolio of credit exposures. Internationally active banks will look at the geographic location of their private sector credit exposures (including non-bank financial sector exposures) and calculate their bank specific CCB requirement as a weighted average of the CCB requirements that are being applied in all jurisdictions to which they have credit exposures – these include all private sector credit exposures that attract a credit risk capital charge or the risk weighted equivalent trading book capital charges for specific risk, IRC and securitisation.

4.13 The weighting applied to the buffer in place in each jurisdiction will be calculated as follows:

‘Bank’s total credit risk charge that relates to private sector credit exposures in that jurisdiction (ultimate risk basis to be used; i.e. jurisdiction is the country where the guarantor of the exposure resides, not where the exposure has been booked)’

\[ \text{divided by} \]

‘Bank's total credit risk charge that relates to private sector credit exposures across all jurisdictions’
5. Commentary/analysis of the Countercyclical Capital Buffer

5.1 Below is a link to the Table of Issues that AFME has sent to BCBS on behalf of its members.

Table of Issues

5.2 A summary of the areas of primary concern can be presented as follows.

Macro-prudential toolbox

5.3 The countercyclical buffer is only one in the suite of macro-prudential tools but it is one which raises methodological questions, concerns over potential redistribution effects and it is also likely to be complex to implement in practice. AFME members would welcome a further articulation and evaluation of the full range of macro-prudential tools, and in particular their interaction with the CCB.

Interaction with Basel III framework

5.4 AFME members would welcome further clarification and assessment of the interaction between the CCB and other parts of the Basel III framework, as they are concerned about the potential duplication of capital requirements, potentially building excess conservatism, especially as it seems unlikely in practice that the buffers would be able to be withdrawn as quickly as suggested. In particular, members would like clarity on the CCB’s interaction with forward looking provisioning, use of through the cycle and downturn parameters in credit and market risk models in Pillar I and other measures.

Aggregation of credit exposures

5.5 AFME members would welcome further clarity on the manner in which credit exposures are to be aggregated. Any approach adopted may give rise to potentially significant infrastructure requirements for banks, which may be unnecessary given other changes being introduced to address pro-cyclicality.

5.6 The operational requirements are unclear and leave open the possibility of large differences between countries, as well as differences to existing country risk methodologies. This means that the operational cost of providing the underlying data required could significantly exceed the costs of the proposed buffer. In particular the BCBS guidance in footnote 54 could require a whole new set of calculations, particularly if jurisdictions require banks to look for the jurisdiction of ultimate use. Trading activities are particularly difficult to bring into the concept and urgent clarification is needed from the BCBS on some of the operational difficulties of the country exposure determination.

6. Transitional Regime

6.1 The countercyclical buffer regime will be phased-in in parallel with the capital conservation buffer between 1 January 2016 and the year end 2018 becoming fully effective on 1 January 2019. This means that the maximum
countercyclical buffer requirement will begin at 0.625% of RWAs on 1 January 2016 and increase each subsequent year by an additional 0.625 percentage points, to reach its final maximum of 2.5% of RWAs on 1 January 2019.