Association for Financial Markets in Europe

International Swaps and Derivatives Association, Inc.

25 November 2010

Dr Mario Nava
European Commission
DG Internal Market and Service
Banking and Financial Conglomerates Unit
Bruxelles, Belgium

Re: **Consultation on countercyclical buffers**

Dear Dr Nava,

The Association for Financial Markets in Europe (AFME)[1] and the International Swaps and Derivatives Association (ISDA)[2] welcome the opportunity to comment on the consultation on countercyclical buffers (the Consultation) and would like to express their support for the European Commission's (the Commission's) furtherance of the debate on the reforms in this area. This consultation on countercyclical buffers serves as a helpful addition to the Commission's on-going dialogue with the industry on capital measures. We particularly welcome the willingness of the Commission to seek and address industry views on the Basel proposals, as this has been absent from the discussions on this topic so far.

In addition to the answers to specific questions posed by the Commission (Section B), we have outlined Key messages (Section A). We also attach, for information, and to supplement our response, the joint GFMA ISDA response to the Basel Committee Banking Supervision's consultative paper 172 (BCBS 172) on countercyclical capital buffers (Annex 1), submitted in September this year.

[1] EC register of interest representatives 65110063986-76

[2] EC register of interest representatives 4663241096-93

A Key messages

We recognise the need for the Commission and relevant regulators to address excessive procyclicality and to help ensure that banks are adequately capitalised when entering a downturn.

Our main concerns resulting from the consultation on countercyclical buffers are as follows:

- **Level of cyclicality in the Pillar 1 requirements.** The extent of cyclicality introduced by the CRD is not yet known owing to the paucity of data. The framework was implemented in the EU at the end of 2006 and is currently undergoing radical change, so the implications, both in terms of the cyclicality of the new requirements and the impact on the wider economy, are difficult to determine. While we understand the political imperative for delivering a regime that addresses excessive procyclicality, it is difficult to identify the appropriate level for any buffers until the detail of the Pillar 1 requirements are set out and the implications of these new rules for cyclicality have been fully understood. To the extent that procyclicality in capital requirements is deemed to exist and at a level that is detrimental to financial stability, any implementation prior to a full cycle of all major countries adopting Basel III should be modest in scale.
- **Macro-prudential toolbox.** We think that further articulation of the full range of macro-prudential tools and how they would be used is required. In our view, the countercyclical buffer is only one of the available macro-prudential tools and it is difficult to comment on the consultation without understanding how it would work in the context of the wider macro-prudential debate. To our knowledge, very little research has been undertaken to assess the applicability of the range of macro-prudential tools; the likely interaction of the countercyclical buffer with other policy tools; and the implications of using various combinations of measures. In order to fully assess the suitability of the countercyclical buffer proposals put forward by the Commission and other relevant bodies, more work needs to be done to examine the practical and quantitative implications of using the countercyclical buffer as part of a broader macro-prudential toolbox.
- **Interaction with other parts of the framework, including Pillar 2.** We would like to understand how the proposal for countercyclical buffers is intended to operate with the other measures that are being considered to address procyclicality. For example, forward looking provisioning is likely to reduce the need for a buffer by bringing forward recognition of losses and thus will have a countercyclical effect by putting aside profits. In addition, the extent to which firms' internal rating systems adopt a 'Through the Cycle' approach and the use of downturn parameters will also reduce the need for countercyclical buffers. Further, we would like to understand how the buffer interrelates with other measures already within the framework to address procyclicality, such as stressed Value at Risk (VaR) and stress testing in the banking book. While we understand the authorities' desire to ensure that firms are adequately capitalised when entering a downturn we remain concerned by the potential for duplication of capital requirements for this risk.

- **International consistency.** We are very supportive of the consideration of other alternatives to the proposals in BCBS 172 in addressing issues raised by the industry participants. The majority of Members prefer Commission Option A (bank specific approach under Pillar 2), although we recognise that it does not align with that proposed in BCBS 172. That said we continue to believe that international consistency is very important and would therefore urge the Commission to raise Option A with the Basel Committee and encourage its adoption as the global standard. If the Basel Committee does not endorse Option A then we will want to reflect further in light of our ongoing concern in relation to international consistency.
- **Timing of proposed measures.** We would urge the Commission to take sufficient time to develop detailed recommendations regarding countercyclical buffers. It is vital that proposals taken forward are workable and proportionate in relation to the risks posed. Ambitious deadlines should not take priority over delivering a countercyclical buffer proposal that can be implemented in an operationally efficient manner. We therefore think that countercyclical buffers should not be included within the CRD 4 proposal, but within a subsequent amendment to the CRD.
- **Practicality/application.** We are very concerned that the proposal based on BCBS 172 gives rise to significant operational challenges for the firms in implementation. We appreciate the introduction of two further options for consideration that may address some of the problems, particularly the bank specific buffer approach. However we appreciate that such an approach will create issues for supervisors in terms of delivering a 'level playing field' across institutions.
- **Release of the buffer.** The use of the buffer is one of the core concerns, and one that we consider is not dealt with in insufficient detail. Whilst we recognise that the Commission states that the buffer should only be deployed when certain conditions are in place, we feel the criteria are unclear. In the absence of more detailed guidance around release the Commission runs the risk of the countercyclical buffer being perceived as a new minimum requirement. This could in turn have serious consequences in the event of the buffer being released and the message it sends to the market.
- **Roles of regulatory bodies** Whilst we agree with the Commission's broad outline for a pan-European coordination and consistency of buffer decision, we would urge the Commission to ensure that the respective roles of the ESRB, the EBA, and the national regulators are clearly defined and do not overlap. We would urge the Commission to apply the following principles in developing the detailed descriptions of roles to be played by the aforementioned bodies: clear segregation of responsibilities; certainty and finality of decision-making; and clear and efficient three-way communication process. To the extent that standards are developed we also urge that effective policy making processes, including proper consultation, are put in place.

B Response to questions

1. Could the general orientations indicated above foster a build-up in bank capital in good times and facilitate its release in bad times? Would you prefer the approach to determining the bank-specific buffer add-on as set out in paragraph 12, or would you prefer the alternatives set out under A and B? Please give reasons for your answer.

We support the desire to address excessive procyclicality in the capital framework. However it is important to consider the prior questions: whether capital requirements are the only macro-prudential tool and, if they not, at what point should they be used. To answer these questions it is important to consider the purpose of and range of tools for macro-prudential regulation and how they should be used. In the absence of further detail on these issues we find it difficult to give a complete response to this consultation.

We do not believe that macro-prudential regulation should aim to manage the economic cycle, but rather to help ensure that firms are adequately capitalised to withstand it. We are therefore concerned that the countercyclical buffer is perceived as being a tool to manage the credit cycle. Given that the countercyclical buffer does not address credit demand and since credit is not only provided by CRD firms, a buffer will have limited success as a tool for managing the credit cycle.

As regards countercyclical buffers themselves, any proposal to require firms to hold additional capital will foster the build-up of capital. The key to success will be in determining the point in time at which to require capital to be held; targeting the requirement so that it appropriately captures the risk, taking account of bank specific factors, such as the systems and controls around lending; and, release of the buffer when appropriate to do so.

Regarding the potential alternatives put forward by the Commission – Basel Committee approach; Commission Option A; and Commission Option B – our preferences are as follows:

The majority of Members prefer Commission Option A (i.e. a bank specific approach under Pillar 2), as we think that it would meet the objectives of the proposal, would take account of bank specific exposures and control environment and could therefore be appropriately targeted. In particular it would allow the buffer to be targeted at the sectors where the risk is heightened rather than imposing a blanket provision that would affect all credit exposures. For example, if there was a perceived problem in the commercial real estate sector, the buffer could be used to target those institutions with exposures in that sector and to limit the buffer to the extent of those exposures. Moreover, it could use firms' existing country concentration risk systems as input into the determination of geographic spread, and thus cost effective to implement. We recognise that this option is not without its own challenges, particularly international consistency and the delivery of a level playing field across institutions and jurisdictions. Although this option is not in line with the consultation produced by the Basel Committee, we strongly believe that international consistency is vital. As a result we urge the Commission to raise this option with the Basel Committee and encourage its adoption as the international standard. If the Basel Committee does not endorse the firm specific approach, we will need to consider the issue further. As regards a level playing field this option will require enhanced dialogue with firms to ensure that buffers are put in place consistently and at the appropriate time. An important consideration in the success of this option will be the role of the European Banking Authority (EBA), which is considered in Question 6.

Whilst we can see the attraction of the Basel Committee's approach to calculating countercyclical buffers to regulators (i.e. calculating the buffer based on the location of obligor), we think that it will be operationally problematic and burdensome owing to the difficulties associated with determining the location of the source of repayment, particularly where cross border credit risk mitigation is involved. It may not be possible for firms to build upon their existing country concentration risk systems to deliver this and therefore separate systems may be required. Moreover this would require consistent policy to be adopted across all institutions and regions, which would be difficult to achieve in practice and could also be very costly for firms to implement. We would therefore recommend that the Commission, as well as other regulators, do not lose sight of the need to develop an approach that is not only commensurate to the risks in question but one that is also cost-effective.

We also do not regard Commission Option B (i.e. add-ons for jurisdictions where credit was granted) to be the optimal way forward. We do not believe that it meets the objectives of the proposal and it also has operational difficulties associated with it.

One area that remains unclear in all the options, as outlined in the key messages, is discussion of the release mechanisms for the buffer. We would like to discuss this issue further with you.

2. Would the approach for dealing with internationally active banks set out in paragraphs 12 to 20 help ensuring a level playing field between domestic and foreign (located in other Member States and third countries) banks? Could there be an incentive for regulatory arbitrage since credit institutions may gain benefits from booking exposures in jurisdictions with lower capital add-ons? Which of the three alternatives reduces the chances of regulatory arbitrage? Are there other ways in which potential regulatory arbitrage could be mitigated?

There are difficulties associated with creating a level playing field with all of the options considered, as, inevitably buffer decisions will involve an element of judgement. Superficially an approach based on the location of the obligor may appear to create a level playing field but if the costs of this precision outweigh the benefits of this approach, as we believe, then this is not an option that should be pursued. Furthermore, the proposal does not, for example, recognise the difficulties of introducing credit risk mitigation, which will create further complexity. Additionally, for jurisdictions that do not implement their own buffer decisions there could be differences in the level set by the home states for firms operating in those jurisdictions. If supervisors have concerns about booking practices we think that there are other tools at their disposal to address these issues.

With respect to the potential for creating incentives for regulatory arbitrage, we are of the opinion that the primary driver for determining the location of credit granting is not the credit institution, or the regulatory framework, but rather the obligor and its needs. The creation of exposure in a particular jurisdiction depends primarily on the appetite of potential obligors, over which credit institutions have limited influence.

We are unable to provide further comments on the potential for regulatory arbitrage in the absence of a fuller picture of the overall proposals for macro-prudential regulation.

3. Should the buffer requirement apply at a solo, sub-consolidated and consolidated basis (i.e. in accordance with the scope of application laid down in Articles 68 to 72 of 2006/48/EU)? Should supervisors be entitled to require credit institutions to hold the counter-cyclical buffer on a solo basis?

Members strongly oppose the application of the buffer requirement at a solo, sub-consolidated and consolidated levels. Such multiple application of capital requirements at various levels is disproportionate. Overall, our preference would be for the buffer to be applied at a single point and that it should be applied at the consolidated or group level. We believe that application at group level would be intuitive and in line with how country risk is viewed and managed and therefore take into account a firm's operations and governance model. Such an approach is analogous to the Commission's own view on the position of branches.

If the solo regulator is given the power to require capital to be held at the legal entity level, then it is imperative that the regulations make clear that this capital does not also need to be held at the sub-consolidated and consolidated levels.

4. Could a ceiling of 2.5% for the counter-cyclical buffer limit unduly the ability of national authorities to ensure the resilience of their banking system and constrain excessive credit growth? Please explain your views on the basis of expected costs and benefits.

As already noted, we do not think that countercyclical buffers should be seen as a tool to constrain excessive credit growth, but as one of the potential macro-prudential tools available to the regulators to protect the resilience of the banking system. We believe that the ability of a buffer to limit excessive growth is limited: banks are not the only institutions with the ability to provide credit; there are no mechanisms in consideration that would manage or restrict the growth in demand for credit (the proposals only consider supply); and the measures proposed would only address aggregate credit growth and thus are not suited to addressing credit growth in a specific type of lending.

In terms of a cap on any countercyclical buffer, the question refers to the buffer limit already set in Basel, which presupposes the approach proposed in BCBS 172. However, even with a bank specific approach, we do not think that setting a ceiling of 2.5% for the buffer would potentially limit the ability of national regulators to respond appropriately if the resilience of the national banking sector was under threat. In addition to the buffer, the regulator could apply one of the other macro-prudential tools available. We would like to see the role of these additional tools debated at more length.

Another consideration that we think is of relevance, is that if the counter-cyclical buffer is included within the CRD (although we think that it should not be included as part of CRD 4), the Commission has indicated that it will become a maximum harmonisation Directive and therefore a limit would seem to be appropriate.

5. Should decisions for the counter-cyclical buffer be made transparent, explained and communicated to the market? Do you see a role for the ESRB in this regard? Please explain the reasons for your reply.

We are generally supportive of transparency and disclosure. However the answer to this question will depend on the purpose of the countercyclical buffer, within the range of macro-prudential tools, and the approach taken (Basel, Option A or B).

We do not think that the purpose of countercyclical buffers should be to provide a warning to the market. We would envisage other macro-prudential tools, such as European Systemic Risk Board (ESRB) and central banks' reports on financial stability, provide an early warning of the potential build up of risks to the system. We would certainly agree that there should be transparency as to the process of risk identification and decision making. There is undoubtedly a role for the ESRB in this regard. However, we would envisage the buffer acting as a 'tool of last resort', when other measures have failed and supervisors need to ensure that firms hold sufficient capital when entering into a possible crisis. The transparency of the process and decision making will be determined by the approach taken to setting buffers.

As indicated earlier we are in favour of a firm specific approach. Under this option we think it could be counterproductive to disclose buffer decisions. Public disclosure of bank specific buffer decision could be misinterpreted by the market participants and ultimately detrimental to the bank in question. In the worst case scenario, such level of transparency could increase the potential for systemic risk, as it could result in a run on the bank in question. However, if the buffer decision is made in accordance with the Basel proposal, then we would see a greater role for transparency of the decision making process.

In both options, however, we would see the role of the ESRB as advising on the risks building up in the system, as opposed to being a party to the buffer decision making process. We see a role for the ESRB in communicating the results of economic forecasts and providing insight into potential problem areas in the market. We do agree that the role of the ESRB should be clarified and would urge the Commission to provide further detail in the feedback to this consultation.

6. What are your views on the following potential roles for the ESRB and EBA:

(a) The development of principles and technical standards as regards the exchange of information and promotion of consistency of the buffer decisions?

We do not envisage ESRB playing a role at all in relation to the development of principles and standards in relation to countercyclical buffers. As discussed above, we would expect the ESRB to be primarily concerned with macro-economic level forecasts, providing advice on risks building up in the system.

In contrast, we view the EBA as a standard setter in relation to the process for determining countercyclical buffers and as 'gate-keeper' in safeguarding the consistent application of standards. It should also, as already provided for by the legislation, have a role to play in dispute settlement. In addition, we believe that the EBA has an important role to play in the college process and should foster the co-operation between national regulatory authorities. That said, we do not think the EBA should take the lead role in the setting of the actual buffers (i.e. the percentage applied).

There are, however, a number of important questions, regarding the role and operation of the EBA that require further elaboration; in particular: the effective regulation processes that should be in place around policy development (including consultation), individual firms' ability to raise issues with EBA directly; and confidentiality of firm specific data (e.g. there should be no unnecessary public disclosure that could potentially have an adverse effect).

(b) Issuance by the ESRB, on the basis of its regular risk assessments, of specific recommendations on the levels of counter-cyclical buffers established by national authorities?

We do not support the proposal for the ESRB to publish specific recommendations on the buffer levels; these should be set by national authorities. The ESRB should issue statements/views regarding risks in the system, and it should be the role of the EBA to engage with the individual national regulators to ensure that agreed standards are followed.

(c) Oversight by the EBA to ensure that buffers decision are implemented in an efficient and harmonised way?

Whether the Commission takes forward the Basel proposal or the bank specific approach we would envisage a role for the EBA. As noted in (a) above we would see a role for the EBA in setting standards around the buffer setting process. However, we would not envisage a role for the EBA in setting, or deciding, the actual buffer percentage for an individual firm (other than in its capacity as party to the college, where we would envisage buffers being discussed) or country. We also see a role for the EBA in ensuring that national authorities are applying those standards in practice, through, for example, peer review. Where a national regulator has not abided by the standards put in place, we believe that there are already proposed mechanisms to deal with non-compliance. As noted above, it remains unclear to us as to whether firms could also bring issues to the EBA's attention directly or should do so via national authorities.

(d) What are your views on the possible interaction between the respective roles of the ESRB and the EBA?

We welcome the Commission's efforts to ensure the interaction between the roles of the ESRB and the EBA are properly considered. We would also urge the Commission to examine the interaction between the above mentioned bodies, national regulators and firms. In the absence of detail on the ESRB and EBA (and other ESAs), it is not possible, at this stage, to give a comprehensive view of the potential interactions between these key parties. However we would like to reiterate our concerns outlined in the legislative process regarding the need for effective policy making processes, including proper consultation, and confidentiality of firm information.

7. What type of own fund instruments should be used to meet the counter-cyclical buffer requirement and why?

In answering this question, it is important to consider the purpose and likely usage of the counter-cyclical buffer and also the proposed revisions to the definition of capital and thus its subsequent usage. In this respect we have looked to, and in the absence of draft Directive text, used, the Basel terminology. The Basel Committee has indicated that Tier 1 (Core Tier 1 – primarily equity and reserves after deductions; and Non-Core Tier1 – including certain hybrid instruments) is 'going concern' capital and that Tier 2 (subordinated debt) represents 'gone concern' capital. The BCBS 174 consultation proposes that Non-Core Tier 1 and Tier 2 instruments must have a conversion to equity feature at the point of non-viability of the bank. In addition the Basel Committee has indicated that the buffer should be supported by common equity or other fully loss absorbing capital, but has not yet specified what is meant by the latter. However the Pillar 1 and 2 requirements may be met by Tiers 1 and 2. The status of the capital conservation and counter-cyclical buffers are uncertain as they appear to be neither Pillar 1 nor Pillar 2.

As indicated earlier we see the purpose of a countercyclical buffer as being to help ensure that firms are adequately capitalised in advance of a credit shock, where other warning measures have failed to address perceived risks to the system. The buffer should be used if that shock comes to fruition. However, forecasting is not an exact science, and even if a buffer is thought necessary there is no guarantee that it will need to be used.

With the above context in mind, common equity can obviously be used to support the buffer. The question then becomes what other instruments may also be used.

We believe that capital should be defined more broadly than common equity and that the eligibility of instruments with contingent equity features should be considered. Indeed the ability of broader capital instruments to support buffers has already been contemplated in one jurisdiction. However, we do recognise that the forthcoming consultation on going concern contingent capital will have a bearing on this debate and therefore think that it is premature to come to a definitive view on this question at this stage. We would also ask the Commission to clarify the likely timing and legislative vehicle through which contingent capital will be addressed.

8. How should "exposures" be weighed to meet the objectives of the countercyclical buffer (nominal or on the basis of Risk Weighted Assets)?

We believe that risk weighted exposures give a much better indication of the level of risk associated with given positions than nominal and are therefore more appropriate.

9. Should the counter-cyclical buffer apply to all exposures or be limited to certain types of exposures and if yes which? Please support your answer with reasons.

We do not believe that countercyclical buffer should apply to all exposures on a firm's balance sheet if our understanding of the objective of this policy tool is correct – i.e. to ensure that firms are adequately capitalised to withstand a credit shock. As a result, the scope should limited to the banking book, subject to the caveat in the paragraph below. Operational risk would obviously be out of scope. We also believe that the buffer should not be applied to the trading book for the following reasons:

- credit risk losses are only associated with a subset of exposures included within the trading book;
- the capital requirements, in the form of stressed VaR and the IRC charge, already take account of stressed market conditions in Pillar 1 and therefore do not require an additional counter-cyclical buffer; and
- the trading book is the subject of a fundamental review, for which the results are not yet known.

In relation to the banking book, we think that it is important for the framework to represent a coherent whole, and in particular that the countercyclical buffers take into account the requirements imposed on the firms by other parts of the framework. In this regard we think that highly liquid assets, as determined in relation to the liquidity standards, should be excluded in order that firms should not be penalised for this required activity. In addition, since by definition these assets are highly liquid, it should be possible to minimise credit losses arising from a bubble bursting. Indeed, these assets are just the ones likely to rise in value during a stressed period. Further, as noted above, we think that consideration should be given to attaching the buffer only to the exposures in the sector (or sectors) where a risk has become evident rather than applying it to all credit exposures.

10. In your view, should investment firms be excluded from the counter cyclical buffer capital requirement? Please support your answer with expected costs and benefits.

Given our comments above regarding the scope of application we would agree that it would seem appropriate to scope out firms who do not take on significant credit risk from the counter-cyclical buffer requirement. To this end we would suggest that those investment firms that meet the conditions of Article 20(2) and (3) of Directive 2006/49/EC could be excluded. As regards full service investment firms, our view on the applicability of the buffer to the trading book would suggest that they should be included to the extent that they have a significant banking book. As a result we would recommend the development of a threshold. Investment firms with banking books below this threshold would not need to apply a countercyclical buffer.

11. Do you have other comments or suggestions?

As noted in the introduction, we attach for your information, our response to the Basel Committee on BCBS 172. In the absence of further information from the Basel Committee we regard the points made in that response as still relevant, while acknowledges that in developing this consultation, the Commission recognises some of the issues raised.

We would be pleased to discuss the any of issues raised in this submission with you or to provide further information if that would be helpful.

Yours sincerely,

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AFME (Association for Financial Markets in Europe) was formed on November 1st 2009 following the merger of LIBA (the London Investment Banking Association) and the European operation of SIFMA (the Securities Industry and Financial Markets Association). AFME represents a broad array of European and global participants in the wholesale financial markets, and its 179 members comprise all pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with SIFMA in the US, and the Asian Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association), and provides members with an effective and influential voice through which to communicate the industry standpoint on issues affecting the international, European, and UK capital markets. For more information please visit the AFME website, www.AFME.eu

ISDA (The International Swaps and Derivatives Association) was chartered in 1985 and has over 820 member institutions from 56 countries on six continents. Our members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Since its inception, ISDA has pioneered efforts to identify sources of risk in the derivatives and risk management business and reduce those risks through: documentation that is the recognized standard throughout the global market; legal opinions that facilitate enforceability of agreements; the development of sound risk management practices; and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.

International Swaps and Derivatives Association, Inc.

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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 cyclicality in the Pillar 1 requirements -** The extent of cyclicality 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 cyclicality 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 cyclicality 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.[3]

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 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

[3] 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.

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 26th 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. Cyclicality of the regulatory capital requirements

As noted in the December consultation, the extent of cyclicality 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 cyclicality 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[4].

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.
- 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.

[4] 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.

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 cyclicality 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-source 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 7th 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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