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Response to the Basel Committee Consultative Paper on Countercyclical Capital Buffer Proposal

Key Points

The EBF appreciates the extensive research work made by the BCBS in striving to know more about the behaviour of credit across economic cycles, as well as its relationship to economic variables that could help identify situations of excessive credit growth at a macroeconomic scale.

In particular, the complementary working paper illustrates the usefulness and drawbacks of a wide array of indicators. This empirical investigation will contribute to the knowledge base of the authorities in charge of monitoring the systemic risk of the financial system (in the EU, the future European Systemic Risk Board).

As regards the two different layers of capital buffer put forward by the Basel Committee, the EBF is of the following opinion:

1. We strongly oppose to *building buffers* by restricting the banks' management capacity to set the dividend pay-out policy. It would merely represent an increase in the minimum capital requirements, it could send out wrong signals to the capital markets about the banks' financial strength, and also it would put banks at a disadvantage amongst its peers from other economic sectors.
2. We understand the problems associated to pro-cyclicality but we are very critic about many details of the proposal put forward in the consultative paper. We think that the countercyclical buffer proposal should be carefully reviewed taking under consideration the specific points set out below.

As a matter of summary, we have some reserves as to the extent this study should be translated into specific prudential rules affecting the capital structure of banking institutions.

Firstly, the control of pro-cyclicality should not rest on the solvency of banks. Higher capital requirements should be used cautiously as they may bring in other – negative – implications. Instead, other macroeconomic variables may better serve the objective.

In second place, the pro-cyclicality issue is already present in a number of existing and new prudential measures, such as forward-looking provisioning systems or stress testing. The joint effects of the combined countercyclical tools should be fully assessed before setting the level of any new countercyclical buffers.

Thirdly, the timing of implementing (if to be implemented) countercyclical capital buffers based in leading indicators would be crucial, as it would have to be incepted only in a clear credit cycle growth period, and would probably justify a long period of parallel testing and phasing-in period. Otherwise, it could have negative implications in both bank's financial strength and stakeholders' perceived confidence in the sector.

Finally, there is a need for differentiation in order to avoid penalising banks that do not show outstanding levels of credit growth during phases signalled as of excessive credit growth in the economy they operate.

We consider that excessive credit growth (and the downward shift in credit quality involved) stems essentially from inadequate risk management practices. Supervisors may be in the best position to assign the capital requirements commensurate to the degree of risk taken on by individual banks during times of credit growth.

We deem this contribution as a valuable input for supervisors in their judgement but we do not think it should be left as a rules-based mechanism.

As a conclusion, we think the Basel Committee papers bring light to all stakeholders in understanding the overall behaviour of credit across economic cycles, but the translation into precise solvency rules would need to be carefully reviewed in conjunction with other measures, notably the forward looking provisioning system. The role of the supervisory review process in finding out the specific institutions which show an excessive credit growth during the upside would also need to be elaborated, together with guidelines geared to prevent from such behaviours. Additional minimum capital requirements and restrictions to dividend pay-out policies should not be implemented.

INTRODUCTION

The European Banking Federation is pleased to respond to the consultation on the document for a countercyclical capital buffer proposal issued by the Basel Committee in July 2010.

This response should be read together with the EBF position towards the Basel Committee proposals on *Strengthening the resilience of the banking sector* and the *International framework for liquidity risk measurement, standards and monitoring*¹, as long as these refer to the regulatory reform from a broader perspective, although some details of the proposals

¹ Response to Capital proposals (<http://www.bis.org/publ/bcbs165/ebfc.pdf>), response to Liquidity proposals (<http://www.bis.org/publ/bcbs165/ebfl.pdf>) and complementary paper *Finding the right balance* (<http://www.bis.org/publ/bcbs165/europeanbanking.pdf>).

were still pending to be known, *inter alia* those related to the countercyclical capital buffer under the subsection of *excessive credit growth*.

The complementary BIS Working Paper² referred to in the consultative document has also been examined.

SPECIFIC POINTS

1) Macroeconomic approach

We are of the opinion that no rules-based system to tackle excessive credit growth by prudential regulation should be mixed up with monetary and fiscal policies. The latter are meant to be the most effective and flexible measures for this purpose.

The indicators proposed in the consultative paper to anticipate stages of excessive credit growth could be for use by the authorities in charge of monitoring the systemic risk of the banking sector. These authorities could eventually put in force measures, under their powers, geared to keep credit growth under control.

In any case, we think it advisable to recommend regulators to control credit growth first and foremost by macroeconomic variables (for instance, interest rates and minimum reserve requirements of central banks). Increasing capital requirements should be a last resort measure.

2) Wide range of countercyclical measures

The design of new countercyclical measures should be viewed from a wider perspective. There is already a number of existing prudential measures which contribute to reducing the pro-cyclicality, as well as new proposals in the regulatory reform underway, namely:

- The stress-testing within the supervisory review and evaluation process. In our opinion, the Internal Capital Adequacy Assessment Process is the right place for banks to perform their forward-looking capital planning and stress testing, and for supervisors to review and evaluate the adequacy of banks' capital.
- The forward-looking provisioning system under discussion. The EBF supports the provisioning based on Expected Loss (EL) model and has put forward a proposal for a provisioning model based on the EL concept, which captures the economic reality of the lending activities of financial institutions in line with the BIS six principles to achieve sound EL provisioning approach. We believe that the forward-looking element of the provisioning system will contribute to mitigating pro-cyclicality.
- The potential introduction of a leverage ratio as a backdrop capital level.
- The role of contingent capital. Instruments which can be converted into equity in the event of a crisis will ensure that banks have sufficient capital at their disposal to cushion them against adverse economic developments. In this regard, the proposal of a countercyclical buffer should be discussed together with the role of contingent capital. The buffers should be allowed to be made of contingent capital.

² Countercyclical capital buffers: exploring options (BIS Working Paper No 317, July 2010)

We think there is need to carry out a holistic analysis of all the countercyclical measures available and decide on the role that a new countercyclical capital buffer might play in the overall context.

3) *Simplicity*

The various capital buffers and the variety of measures meant to tackle the pro-cyclicality issue make it all somewhat confusing and overly complex.

We understand and share the concern of policy-makers about the consequences of excessive credit growth. It should be kept under control with actions geared to discourage banks to loosen their credit standards during the upside of the cycle. But we firmly reject a new capital conservation buffer because it would have no countercyclical effect and would merely increase minimum capital requirements.

Banks would see more appropriate a single buffer definition. The amount and nature of the buffer would have to be determined on a case by case basis, at the consolidated level, as a result of the supervisory review and evaluation process.

The proposals in the consultative paper should be turned into guidelines geared to ensure homogeneity among supervisors. If the Committee pronounces to fix a minimum general buffer based on macroeconomic indicators, it should be kept low and be complemented with a variable buffer assigned on an individual basis.

4) *Distributions*

The proposed additional standards restrict the capital management capability of the bank even while the bank still has capital above that required by the minimum capital ratios.

The competitive edge of the banking industry will be at risk. Reducing pay-out will directly turn banks common equity less attractive, while the stricter definition of capital will force banks to raise equity of this kind.

A point of concern is that disclosure obligations may lead investors to misinterpret the measures taken notably the dividends pay-out constraints, with the ensuing serious risk of reputational damage.

5) *Keeping the right incentives*

We agree in general that credit growth should be monitored by the authorities. These should take actions to limit excessive credit growth in good times. Nevertheless, we would like to draw the attention of the Basel Committee to the fact that countercyclical measures should not be imposed on entities that have shown moderate credit growth behaviour during good times. Discrimination is essential to refrain from penalising banks that do not show outstanding levels of credit growth during phases signalled as of excessive credit growth in the economy they operate.

If all banks in an economy are treated the same way, irrespective of their risk behaviour, higher capital requirements would punish conservative banks and, ultimately, would incentivize more aggressive policies in order to preserve the return on equity after the imposition of unwarranted add-ons.

Prudent bank management should not be discouraged by giving the same general treatment. On the contrary, the capital requirement should be assigned according to the way the risks are managed in every institution.

6) Sound risk management and governance

We consider that excessive credit growth (and the downward shift in credit quality involved) stems essentially from inadequate risk management practices. Supervisors may be in the best position to identify those banks that may be loosening the credit standards during the upside of the cycle as opposed to others who do not take on additional risks. The soundness of the banks' risk management practices, systems and controls, as well as the strength of the internal governance framework, should be considered.

7) Colleges of supervisors

The proposal and its interplays with other prudential measures becomes quite complex in the case of cross-border groups. They are all likely to end up duplicating requirements without having a fair rationale of the risks involved.

In determining the buffers applicable to every jurisdiction, there should be global agreed standards and processes in place, subject to oversight and monitoring, of the Financial Stability Board (FSB).

We disagree specifically with the provision in paragraph 4 of page 4, where it says that home authorities could complement the buffers set at the local jurisdiction, but they would not be allowed to relieve them.

The proposal demands a huge coordination between supervisors across jurisdictions and between supervisors and those responsible for the monetary and/or fiscal policies in each jurisdiction. Any failure in these entities' coordination may result in artificial asymmetries concerning Banks competitiveness.

Colleges of supervisors should play an important role in avoiding duplication of requirements and in guaranteeing consistency in cross border groups.

8) International level playing field

According to the proposal, the home country authority could impose on its banks stricter requirements (higher buffer add-ons) for exposures booked in host countries than those required in the country where these exposures are originated leading to an unlevel playing field between domestic and international banks. As is explained in the Basel document with this scheme the domestic banks will never suffer a competitive equity disadvantage, but it jeopardises the level playing field for internationally active banks.

Moreover, the different national capital charges could give way to distortions in the funding market. As a result, the proposed introduction of a countercyclical add-on could have considerable industrial policy implications.

There is a need for global standards backed by an international institution like the FSB.

Other point of concern is the huge contribution of capital buffers to the overall impact on the European banking sector. While European banks hold roughly three fourths of the total

lending to the private sector, this ratio is as low as about one fourth in the United States. European banks should not be put at a disadvantage and European borrowers should not necessarily bear the bulk of the new set of global prudential standards.

9) Non-bank credit

The paper rightfully refers to all the credit in the financial system. However, the measures proposed would only affect the prudential requirements of banks. Other financial institutions, which might be at the heart of excessive credit growth, would escape the tighter prudential rules, leaving banks (and ultimately their customers) bearing the costs.

The increase in the banking capital requirements will force banks to raise more capital and these new issues will put an upward pressure on the cost of capital which will be added to their lending rates at least partially, creating incentives for a more market based financing, what means just shifting the risk from a strictly regulated and supervised banking sector towards largely unregulated markets.

Therefore, there would be an issue of unlevel playing field. This asymmetry would need to be solved.

10) Emerging countries

The credit/GDP indicator could unduly penalize emerging markets and therefore European cross-border banks which have significant retail activities in those markets. Emerging economies usually show low credit/GDP ratios when compared with developed economies. As a result of the natural development in these countries, the credit/GDP ratio could grow more than lineally (catching-up effect) and, if the methodology proposed is not refined, could result in a fake excess credit signal just because the credit growth is above its historic trend.

A further weakness of this measure could be that the HP criteria does correct for the various starting conditions of each economy (banking developing level, usually measured in credit to GDP). This would enormously penalise retailers in emerging markets who are still in a catching up process towards western banking developing levels. For example, the average credit to GDP ratio in certain emerging economies is barely 50% whereas in Western economies the figure is as high as 150%. There is need to take this fact into account.

11) Confidentiality

We would like to draw the attention of lawmakers to the sensitivity of the information related to capital buffers. In our opinion, it should only be shared between the bank and the competent authorities within the framework of the supervisory review process.

The buffers set and their drawing down should not be subject to public disclosure. Otherwise, it could be perceived as a signal of weakness by the market. On the other hand, we are doubtful on whether a release of buffers in a recession will actually be welcomed by the market in such a situation.

12) Burdensome implementation

We would like to draw the attention of the Basel Committee to the fact that the implementation of this proposal would entail considerable administrative costs. International banks would have to track each and every transaction in their books in a different way that is not useful for business purposes.

We would suggest introducing a materiality threshold exempting minor exposures of no material significance to the bank’s overall portfolio. The proposed mandatory look-through for structured products and investment funds will also be highly onerous and out of all proportion to the perceived benefits. Adequate account should be taken of this aspect.

13) Concluding: A matter of Pillar II

We strongly believe that any decision on countercyclical buffers should be framed within the supervisory review and evaluation process of Pillar II.

Rather than implementing new rules-based systems such as the one proposed, we would see more appropriate to make good use of the existing tools. In this respect, the Pillar II offers the mechanisms needed to evaluate the risk management of institutions and identify undesirable trends such as excessive credit growth.

Banks carry out forward looking stress testing on material risks they are exposed to, and take this result into account when they make their capital planning and decide on the excess capital level that is needed under Pillar II. It is considered important that each bank be given the opportunity to analyse where their lending portfolio is in the current economic cycle and to calculate excess capital buffers needed based on this. In the extensive ICAAP the objective is among others to ensure that the banks keep sufficient capital to cover all its risks in a foreseeable future. E.g. growth, migration and other relevant risk stress testing will demonstrate the impact on risk weighted assets and capital requirements. This is an appropriate framework to work out measures geared to tackle pro-cyclicality problems within the supervisory review process according to the specificities and the business profile of banks.

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