FBF response to the Commission consultation document on the Countercyclical Capital buffer

The French Banking Federation is pleased to respond to the Commission consultation on Countercyclical Capital buffers. The proposal set out in this consultation paper is closely related to the previous BCBS consultation on the same issues (BCBS 172). Therefore, the first part of our response will incorporate the main points of our response to the Basel consultation and the second part will focus on the European issues raised in the Commission consultation. In our concluding remarks we will describe what an efficient countercyclical buffer should be. We think it's important in this response not only to provide our specific comments on the countercyclical buffer but also to reiterate some of the concerns that we previously expressed in relation to the broad concept of capital buffers. We are aware that the G-20 leaders in their press release endorsed the landmark agreement reached by the Basel Committee including "capital buffers above the minimum requirements that can be drawn upon in bad times". The definition of the counteryclical buffer is still pending and the comments received by the Basel Committee from banks and banking associations generally disagree with the design of the countercyclical capital buffer.

A. GENERAL COMMENTS

1. The proposed countercyclical buffer mechanism involves the issue of mixing up economic or monetary policy objectives with prudential supervision.

By placing some constraints on the supply of credit through additional capital requirements, the proposed buffer mechanism seeks to correct the effect of an overheating of the economy. But the primary responsibility for taking steps to avoid the building up of bubbles in the first place should rest with the economic and monetary policy makers. We do not consider it sound or effective to mix up monetary and prudential supervision.

We question whether the countercyclical buffer, as it is devised, is the most effective way to address the excessive credit supply from a macroeconomic standpoint: indeed it will apply exclusively to regulated institutions and it will affect both existing and new loans instead of focusing on the increase in new lending from regulated and more importantly non-regulated sectors which would in our view appear more effective.

Due to the amount of time needed to detect and measure the excessive credit growth, before taking the decision to impose a buffer in coordination with the various supervisors and give banks an incompressible time period to adjust, one might also question whether the implementation can be swift enough to be effective from a macro-economic standpoint compared to other economic and monetary policies steps that can be taken.

2. We are concerned by the lack of clarity regarding the interaction of the countercyclical capital buffer mechanism with Pillar 2.

We understand from the BSBC consultation paper that the countercyclical capital buffer mechanism is neither a Pillar 2 nor a Pillar 1 measure; this is perplexing and testifies to the difficulty to resolve the issue of the interaction between the proposed buffer and the existing regulatory framework. The paper states that the Pillar 2 approach will need to adapt to accommodate this new instrument; it however provides little guidance as to how to resolve this key matter. Furthermore, we are particularly concerned by the statement that the capital used to meet Pillar 2 requirements should not be used to satisfy the countercyclical capital buffer requirement. In our opinion, this raises serious issues regarding the double counting of capital requirements with Pillar 2. For instance stress-testing already reflects credit cycle effects and may translate into additional layers of capital in Pillar 2 to withstand the macroeconomic environment. We can not be comfortable with a proposal that fails to address how this double counting can be sorted out.

As developed below, we are of the view that the credit cycle effects can already be addressed through a more consistent and effective application of the Pillar 2 approach.

According to the academic research done by economists there is no clear link, or even a negative correlation between credit growth and GDP or a lag between the two curves Therefore we question the economic basis of the countercyclical capital buffer.

3. The proposed buffer has level playing field implications and will create a counterproductive incentive towards disintermediation and a "shadow banking system".

The importance of a level playing field amongst institutions that supply credit cannot be overstressed. The recent crisis has clearly demonstrated that the unregulated sector may play an important role in fuelling excessive credit growth. The proposed buffer may aggravate level playing issues in that respect given the difference of constraints that will apply to the regulated and non-regulated sectors when the countercyclical buffer comes into force. We believe there is a significant risk that the countercyclical buffers will simply create strong incentives to shift borrowing from the regulated banking sector to non regulated entities. Such unintended consequence is particularly of concern, as it would take place at the very times when the risk of credit bubbles would require more discipline to control the excessive supply of credit in the entire financial system.

We also deplore that the buffer should apply equally to every bank in a jurisdiction, thus failing to differentiate between business models, lending policies or degrees of vulnerability to an overheating of the economy.

For example, excessive credit growth could be fuelled primarily by banks with a specific business model or overly active in a particular industry sector. Yet the proposed mechanism would make all banks subject to the countercyclical buffer even though they are unlikely to be equally affected by the macroeconomic environment.

We believe that the prudential approach would be more effective if the additional capital add-ons were specifically targeted to the banks directly responsible for excessive credit growth, or to the ones which would most likely be affected by it.

4. As stated in our previous response to the February 2010 consultation, we continue to have strong reservations about the concept of capital buffers in general, especially because they will inevitably translate into a permanent increase of the minimum capital requirement.

We continue to seriously doubt that the capital buffer mechanism can provide the desired flexibility in capital management that it seeks to achieve. On the contrary, due to the way markets operate, the capital buffers will inevitably translate into a new minimum capital requirement to be respected at all times. This could defeat the initial purpose of the Basel Committee proposal in terms of cyclical flexibility and even undermine the objective of an optimal financing of the economy.

Operating under capital ratios that could imply constraints on earnings distribution would be sending too negative a signal to the market, thereby weighing on the bank's market capitalisation and ability to raise capital. That is why banks will integrate the capital buffer add-ons in the permanent minimum ratios targeted in their capital planning. Furthermore, we remain highly sceptical of the fact that banks would be allowed, by the market, the rating agencies or even their supervisors, to actually use their buffer when the economic situation deteriorates. It is precisely at this time that banks would be expected to hold *more* capital to withstand the economic or financial crisis. This in turn increases the risk that buffers form part of the actual new minimum capital requirement.

As stated in our previous response to the February 2010 consultation, we also believe that the proposed mechanism unduly interferes with shareholder's rights. In our opinion, overly restricting Management's and Shareholders' rights in respect of earnings distribution is an excessive intrusion of the supervisory bodies in the banks' management.

5. More generally, the interplay between the various proposals to reduce procyclicality requires more consideration as it may translate into overlapping and multiple applications of buffers.

The consultation document released by the BCBS in December 2009 identified four measures to dampen the financial system procyclicality, countercyclical capital buffers being only one of them. We are concerned by the risk of overlapping of proposals with neither a clear understanding of the potential interplay between the various measures nor a full assessment of their cumulative and incremental implications.

There is a serious concern that the building-block approach to capital requirement currently underway may not achieve the required level of efficiency anticipated in the absence of a proper consideration and assessment of the risk of double or triple counting through various layers of capital requirement. There is also insufficient clarity about the interaction with the existing or future macro-prudential tools.

We also note that the various layers of capital requirements greatly add up to the complexity of the regulatory framework and tend to reduce clarity and predictability. In terms of bank management, the complex capital buffers mechanism will for instance make it very difficult to adequately reflect actual and projected capital requirements in the pricing of credit.

6. Practical difficulties

We can foresee a number of practical difficulties that could make the implementation of the countercyclical buffers more complex and challenging than expected:

- The Basel Committee acknowledges that the calibration of the additional countercyclical buffer (in terms of sizing the buffer required based on macro economic variables) will remain a **difficult exercise requiring** a **lot of judgment on the part of the regulators**. We deplore that the BSBC paper provides no real guidance in respect of **criteria to be used for releasing the countercyclical buffer** whilst this will be an equally critical decision to take.

- The **one-year advance notice period for the countercyclical buffer** may not be manageable from a capital planning or market perspective: the market or rating agencies may actually reduce this theoretical lead time by requiring for capital raising to be achieved as soon as possible. Markets could become congested if countercyclical buffers were to lead banks to simultaneously reinforce their capital structure in a large number of countries for potentially significant amounts.

- **The markets' reaction** to public announcements made as a result of a decision to impose or release buffers is not fully predictable. There may be unintended consequences: negative sell signals on bank shares, market congestion weighing on the ability to raise capital, increase of credit demand before the buffer is imposed, etc...

B. DETAILED COMMENTS ON THE COMMISSION CONSULTATION

Commission Question 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.

The FBF does not support the alternative suggesting the determination of the buffer by the jurisdiction where the credit is granted. We consider that approach A is preferable and more appropriate which allows defining the countercyclical buffer under Pillar 2. This approach brings consistency of the countercyclical buffer proposal with the existing Basel II regulatory framework. We think that it is the duty of the supervisor where the counterparty is located to appreciate the formation of bubbles and to determine, in consultation with host regulators, the level of a bank specific buffer; either for important branches or foreign subsidiaries.

Commission Question 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?

The FBF does not support the alternative suggesting the determination of the buffer by the jurisdiction where the credit is granted (option B) because the same credit can be booked in different jurisdictions and be submitted to different capital buffers. Proposal B would create incentives for regulatory arbitrage and does not ensure a level playing field.

Commission Question 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?

The counter-cyclical buffer based on Pillar II approach should be set at the most consolidated level by the college of supervisors according to the provisions of the CRD.

Commission Question 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.

We consider that the ceiling of 2.5% already provides regulators enough flexibility to constrain excessive credit growth. However, in our view the main concern is not the ceiling value for the counter-cyclical buffer limit but rather the flaws of the Basel Committee's proposal which have been exposed above. Besides banking industry is not the sole generator of credit growth: unregulated sector may play an important role and cross-border spread of risks exists. In addition, we consider that a more granular approach to countercyclical buffer as exposed under Part C of our response hereunder will be more efficient. However, should a ceiling value have to be implemented, this value should be consistent across European jurisdictions.

Commission Question 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.

FBF supports the disclosure by supervisors of the required level of counter-cyclical buffer by each jurisdiction. As we plead for alternative A (which is a bank specific Pillar II approach) we are opposed to the disclosure of the required height (absolute level or %) of countercyclical buffer for a credit institution, as the buffer level is defined according to a confidential process between the regulator and the bank and could result in disclosing undue or misinterpreted overly granular indications.

Commission Question 6:

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

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

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?

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

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

We think European Central Bank should officially, and not only though its governor, take part in the decisions regarding counter-cyclical buffers. Insofar as buffer is an instrument of monetary policy, ECB's attendance in that process is critical.

As for interaction between ESRB and EBA, it has to be defined by political authorities.

Commission Question 7:

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

FBF asks for the recognition of general provisions in excess of expected loss as a Tier One component and supports the possibility of allowing Tier 2 instruments.

More generally we believe that banks must have the freedom to manage their capital base in accordance with the levels required by their supervisors according to Pillar 2. Capital must be managed **globally** and not be split in different categories covering the different layers of capital requirements (minimum common equity, conservation buffer, countercyclical buffer, and so on).

Commission Question 8:

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

FBF agrees with the Risk Weighted Assets method. The other one would lead to a Basel I approach with a potential concentration on risky counterparties.

Commission Question 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 consider that only the categories of exposures which contribute to a excessive growth of financing supply should be taken into account (which is consistent with our proposition formulated under part C below).

Commission Question 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.

Investment firms and other unregulated financial actors which play a role in fuelling credit growth should not be excluded from the countercyclical buffer framework. Regulators must devise other criteria to limit credit growth of these financial actors in their activities as arrangers, sponsors,, dealers or managers.

Commission Question 11:

Do you have other comments or suggestions?

Please see the rest of our comments

C. CONCLUDING REMARKS

1. We do not support the Commission proposal to introduce countercyclical buffers. Whilst we support the goal of reducing excess procyclicality and making sure the banking system is adequately capitalised to withstand the impact of exuberant credit growth, we sustain the view that incorporating countercyclical buffer in the revised prudential framework should not be a priority at this stage. We believe this issue could be better addressed through the implementation of an effective forward-looking provisioning framework and a consistent application of Pillar 2 rather than through additional layers of regulatory capital buffers. This is all the more necessary as we are not certain that the full implications of the interaction between this proposal and the numerous changes underway in the regulatory framework can be evaluated in a satisfactory way. As a matter of priority, we urge the Commission to focus instead on more robust and critical aspects of the new regulation framework.

Furthermore it is important for us to understand interaction with other parts of the framework including Pillar 2. We consider that capital buffer can already be accommodated within the Pillar 2 approach and that forward-looking provisioning, if correctly implemented, should significantly reduce the need for countercyclical capital buffers.'

In other respects, we think that a granular add-on built on the production of new credits that would receive a higher risk weighed should be more efficient with the objective of preventing excess credit growth. This add-on would apply to new credits and not to the existing ones.

As the proposal acknowledges, countercyclical buffers are not intended to be used frequently (maybe once every ten or twenty years). Obviously, such buffers are also unlikely to be required in the near future, given the current pace of economic growth in most countries. This should be kept in mind especially when considering a proposal that appears innovative, raises challenging questions both conceptually and in terms of implementation and above all fails to be supported by convincing evidence regarding its effectiveness. Furthermore, even though this may be outside the immediate scope of intervention of the Basel Committee, we deplore that the proposal should be envisaged without giving more serious consideration to ways and instruments required in parallel to better control the excessive supply of credit from the non regulated "shadow banking system".

Put in perspective, this sustains the view that incorporating countercyclical buffers in the revised prudential framework should not be a priority at this stage. This is all the more necessary as we are not certain that the full implications of the interaction between the proposal and the numerous changes underway in the regulatory framework can be evaluated in a satisfactory way. As a matter of priority, we urge the Basel Committee to focus instead on more robust and critical aspects of the new regulation framework.

2. Capital buffers can already be accommodated within the Pillar 2 approach.

We believe that the current definition of Pillar 2 already covers the issue that the countercyclical buffers seek to address.

According to paragraph 724 of the 2004 Accord, banks and supervisors must already take account of "*factors external to the bank (e.g. business cycle effects)*" in their Pillar 2 application. This suggests that Pillar 2 should already be able to connect micro prudential supervision with broader macro prudential concerns, as capital requirements under Pillar 2 should factor in not only individual risk profiles but also macroeconomic and cyclical considerations. In our view, additional capital requirements tailored individually for each bank under Pillar 2 is not only fairer but more effective than a fixed countercyclical buffer applied without differentiation to all banks. Effective supervision requires that capital ratios take into consideration business models and lending policies and be raised primarily for the banks that are directly impacted by, or responsible for, the excessive credit growth.

The ability of a number of banks to weather the recent financial crisis was related to the degree of prudence of their supervisors when setting discretionary buffers under Pillar 2 over the minimum capital requirements. We believe that a more effective and consistent application of Pillar 2 across the jurisdiction should eliminate the need for fixed countercyclical buffers. If there is a perceived need to improve such consistency, we urge the Committee to achieve this aim by working towards a more structured and normalized approach of Pillar 2 through the Standard Implementation Group (for example by providing supervisors with more guidance on how to integrate macroeconomic signals in their Pillar 2 approach) rather than pursuing the current proposal on countercyclical buffers.

3. The proposal of the Committee in respect of forward-looking provisioning, if correctly implemented, should significantly reduce the need for countercyclical capital buffers.

Finally, we take this opportunity to reiterate our support to the principle of forward-looking provisioning advocated by the Committee. In our view, the implementation of an effective framework of forward-looking provisioning would greatly reduce the need to resort to countercyclical buffers. As explained in our response to the December 2009 consultation, this is provided that forward-looking provisioning is correctly implemented, i.e. inter alia the accounting and prudential standards are aligned and the framework fully reflects a "through the cycle" approach (as stated previously, we remain opposed to the current 2009/12 exposure draft from the IASB which is not based on a "through the cycle" approach and would fail to reduce cyclicality).

By directly and immediately affecting the P&L, a well-designed forward-looking provisioning scheme would significantly impact the banks' behaviour in case of excessive credit growth and relaxing of credit standards and would help build reserves to weather down cycles. The "reserve cushion" built through forward looking provisioning should in turn be taken in consideration when assessing capital requirements in Pillar 2 and ability of the bank to withstand credit bubbles.

4. A more granular approach to countercyclical buffer should be more efficient

In our opinion, the idea of increasing the global capital requirement by a countercyclical buffer is not the right solution to tame exuberant credit growth. The proposed mechanism will weigh upon all banks even if they stop producing new credits before or if they do not participate in this growth. The provision will be global and will weigh on all kinds of credits..
A **more granular** buffer built on the production of **new credits** that will receive a higher risk weight should be a better solution. It focuses exactly where credits grow too rapidly and on banks that are responsible for it. For outstanding credits, the supervisor is always able to require more capital in the Pillar 2 process if he considers that it is necessary to protect the bank from a concentration of risks in a portfolio and to withstand downturns. The increased risk weight will remain as long as the credits are outstanding. The increase in the risk weight will be decided by the supervisors of the countries where creditors of the new credits are located. The home supervisor will be obliged to incorporate this additional requirement in the Pillar 2 process.