American Bankers Association
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Mary Frances Monroe
Vice President
Office of Regulatory Policy
(202) 663-5324
mmonroe@aba.com

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Secretariat
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002
Basel, Switzerland

RE: Consultative Document: *Countercyclical capital buffer proposal*

Ladies and Gentlemen:

The American Bankers Association[1] (ABA) welcomes the opportunity to comment on the consultative paper (CP) published by the Basel Committee on Banking Supervision (Committee or BCBS), *Countercyclical capital buffer proposal*.[2] We support the Committee's objective of ensuring that the banking sector has adequate capital on hand to absorb losses while maintaining the flow of credit in the economy when the broader financial system experiences stress. We agree that efforts to reduce procyclicality in capital requirements can contribute significantly to improving the resilience of banks and the broader financial system.

However, we believe that a more flexible mechanism to meet these objectives would be superior to the buffer proposed in the CP. The CP calls for a rigid response to an increase in the credit-to-GDP guide, a ratio that is an informative, but not determinant, measure of system-wide risk. We believe that the Basel III capital framework, which already includes a capital conservation buffer and continues the Pillar 2 requirements for an internal capital charge, plus the countercyclical capital buffer, would become a *de facto* new minimum capital requirement. To the extent that procyclicality in capital requirements is deemed to exist at a level detrimental to financial stability, we do not believe that the buffer proposal would address the problem and would impose significant and unwarranted increases in the cost and permanent constraints on the supply of credit that would be a detriment to the broader economy.

National authorities already have the ability to implement measures to counter emerging stresses. It is preferable to allow authorities to take the actions deemed appropriate to address credit bubbles based on a comprehensive assessment of the cause of the stress, the stage of the economic cycle, and other factors that may contribute to or mitigate the stress. Actions based on a full assessment of the facts and circumstances are more likely to be successful in restoring credit markets to a more balanced state. In many cases, it may be appropriate to impose a capital buffer on a bank-by-bank basis, reflecting the fact that stress events have very different impacts

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[1] The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's $13 trillion banking industry and its two million employees.
[2] Basel Committee on Banking Supervision, *Countercyclical capital buffer proposal*, www.bis.org/publ/bcbs172.pdf.

on individual banks, depending on their business model, risk profile, risk management capabilities, and capital resources, among other factors. National authorities have the ability to require bank-specific buffers or to impose other prudential measures under Pillar 2 of the Basel framework.

The proposal to impose countercyclical buffers duplicates unnecessarily other pending initiatives. These include a stricter definition of tier 1 capital, the capital conservation buffer, and a Basel Committee proposal to require that all non-common tier 1 and tier 2 capital instruments have terms and conditions that would cause them to be written-off on the occurrence of a condition of non-viability (including non-viability that is remedied by the provision of public support).[3]

We believe that the imposition of a special countercyclical capital buffer is unnecessary. Advocates of such a proposal should be aware of certain concerns and areas where the proposal would need to be further elaborated before any such buffer could even be workable. It is broadly acknowledged that the concept of procyclical measures in general is a matter of first impression for the Committee and the industry. Therefore, careful consideration must be given to the impact of any such measures on credit and investment decisions, as well as to the potential cumulative impact of this proposal and other recent prudential initiatives.

Given the range of "unknowns" in the implementation of the CP and the potential for unintended consequences, we strongly urge the Committee to devote greater study to these issues in coordination with other international standard setters, such as the Financial Stability Board, and with central banks and other systemic risk authorities—as well as with the financial services industry—before proceeding to finalize a countercyclical capital buffer. We appreciate the study and analysis that was conducted in the BIS Working Paper 317, *Countercyclical capital buffers: exploring options* (Working Paper 317), and would encourage further empirical work before proceeding to finalize a CP program.

Summary of Key Points

- ***The credit-to-GDP guide that would be a trigger for the imposition of a countercyclical capital buffer is an informative, but not determinant, measure of system-wide risk.***

- ***The CP uses too broad a definition of credit for purposes of the credit-to-GDP guide.***

- ***The buffer will become a de facto added capital charge regardless of the stage of the business cycle.***

- ***A one-size-fits-all buffer is inappropriate in many cases and could have serious, negative unintended consequences.***

[3] Basel Committee on Banking Supervision, *Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability*, www.bis.org/publ/bcbs174.pdf.

- ***The need for additional buffer capital should be continue to be determined on a bank-by-bank basis under Pillar 2, depending upon the business model, risk profile, risk management capabilities, and capital resources of the bank, among other relevant factors.***

- ***The ability of a host supervisor to set a buffer for exposures to its jurisdiction could conflict with the interests of home supervisors in maintaining a comprehensive prudential supervisory and regulatory scheme.***

- ***The ability of host supervisors to set buffers also may conflict with or complicate the conduct of monetary and fiscal policies in a home jurisdiction.***

- ***The CP is unworkably vague as to how the buffer scheme would be implemented.***

Discussion

The credit-to-GDP guide that would be a trigger for the imposition of a countercyclical capital buffer is an informative, but not determinant, measure of system-wide risk. The credit-to-GDP guide is a helpful metric that should be one of several measures that a systemic risk regulator would consider in assessing general market trends and the potential for a build-up of systemic risk, but it should not be the sole or primary determinant of the need for a capital buffer. Rather, a range of measures, including measures of bank performance, credit spreads, and credit supply conditions, and consideration of the stage of the economic cycle, are important additional elements that should be factored into a determination of whether and to what extent a buffer is warranted. Indeed, reliance on any single indicator as a predictor of future risk is fraught with danger and could introduce significant distortions in the markets for capital and credit.

The effectiveness of the credit-to-GDP guide in slowing credit availability during expansions may be impacted negatively by the fact that this measure is a lagging, not leading, indicator of asset bubbles. Therefore, the buffer may not be imposed in a timely manner to slow credit growth, and removal of the buffer (if, in fact, it is ever removed[4]) could be delayed, constraining the availability of credit to the detriment of the broader economy.

Moreover, in certain jurisdictions, a build-up of credit exposures may not reflect inappropriate risk but, rather, the growth of business and consumer credit as the country returns to financial health. For example, growth in developing countries or countries that are recovering from economic dislocation may present very different policy implications from the case of growth in more mature or stable economies. The credit-to-GDP guide provides some useful information

[4] See comments below under the heading, *The buffer will become a de facto added capital charge regardless of the stage of the business cycle.*

about the capacity of a market to absorb more debt, but ignores the source of the debt, the stage of the economic cycle in which the debt is incurred, factors that might mitigate the risk of incurring additional debt, or debt-servicing capacity.

Working Paper 317 admits that additional study and analysis is needed in order to understand how countercyclical capital requirements should be implemented. This argues strongly for further review and industry consultation—and possibly even a pilot exercise— prior to imposing a requirement that is likely to have significant impacts on the banking industry, the provision and cost of credit, and national and global economies. The potential for negative, unintended consequences is great, and legitimate prudential concerns about imprudent lending practices that could result in stresses can be addressed adequately through other measures that can be crafted to respond specifically to a particular source of stress.

Before application of a credit-to-GDP guide could be prudently imposed, its role as a "common reference point" would warrant further elaboration and discussion. The CP states that the credit-to-GDP guide is "a common reference point but does not need to play a dominant role in the information used by authorities to take and explain buffer decisions." The CP notes that other variables and qualitative information can be considered, while not ignoring the reference guide. These statements are open to a range of interpretations that introduce uncertainty and potential subjectivity that could be damaging to institutions and markets attempting to understand how decisions to calibrate and implement a buffer would be taken.

In our view, it is absolutely essential to explain in greater detail the role of the credit-to-GDP guide and the leeway granted to allow for other factors in determining the buffer. While we appreciate a movement away from a strict formulaic approach that would use the guide as the sole determinant of when a buffer would be imposed, it is important to articulate publicly the range of considerations that could play a role in these determinations. Again, this is an area for further study and analysis, perhaps in consultation with the Financial Stability Board, central banks, and the financial services industry.

The CP uses too broad a definition of credit for purposes of the credit-to-GDP guide. The definition of credit in the CP encompasses sources of credit from non-bank lenders such as hedge funds, investment firms, and other non-bank financial intermediaries. As a result, banks would be required to hold a buffer for credit bubbles that may result largely from the activities of non-bank financial companies that are not subject to capital and other prudential requirements comparable to those applied to banks. As a consequence, even greater capital costs would be imposed upon banks due to the activities of non-banks, further tilting the competitive plane in favor of non-bank firms.

Imposing prudential restrictions on banks without imposing those restrictions on other firms performing comparable functions does not reduce risk, it merely shifts market share to the non-bank sector. Indeed, by shifting business to non-bank entities that may be following poorer prudential risk-management practices, the overall level of systemic risk could be expected to increase as prudential safeguards are not present to control inappropriate risk-taking. That was clearly evident with mortgage origination in the recent housing bubble.

The buffer will become a *de facto* added capital charge regardless of the stage of the business cycle. Banks generally engage in capital planning over a multi-year horizon, taking into consideration anticipated growth and new activities, as well as changes in regulatory requirements or expectations regarding levels of regulatory capital. The creation of a buffer that could be phased in with a 12-month lead time at the discretion of any one of several national regulators (depending upon the number of "locations" of the bank's credit exposures) is inconsistent with banking business practices and would create a capital level uncertainty that banks may be forced by investor and business management pressure to address by assuming that the buffer will materialize for a significant portion of its exposures.

Indeed, banks could very likely make the strategic decision to maintain the buffer at all times out of concern that there may be a rush to the markets when a buffer is imposed by one or more major jurisdictions, since systemic capital stress is likely to affect the entire industry rather than any one bank. Banks outside of the very top tier of institutions with ready access to the capital markets may fear that the cost of capital could become prohibitive or, in the extreme, that capital may be effectively unavailable. The imposition of restrictions on the distribution of bank earnings if the buffer is not established within the 12-month time period could create a downward spiral in a bank's share price that would only exacerbate its lack of market access. A reduction in distributions of bank earnings would create an adverse signal to market participants about the health and future earnings of the company. This signaling would cause bank analysts and rating agencies to issue negative views of the company, causing investors to reduce their demand for the company's equity, thereby exerting downward pressure on share prices and increasing the bank's cost of capital. Again, in the more likely event of a systemic pressure on the industry, all of this negative pressure could provide a very pro-cyclical shove downward to the industry as bank industry valuations fall at the same time that the entire industry is forced into a scramble for ever-more-scarce capital.

Moreover, it is questionable whether regulators and the markets would tolerate a decline in capital levels when the buffer is no longer needed. Rather, it is likely that a capital level that includes the buffer would be a permanent part of supervisory and market expectations. The natural conservatism of prudential regulators will make permission from them to reduce capital very hard to get.

These factors would cause the bank to maintain the buffer regardless of the stage of the business cycle, a suboptimal and inefficient approach. Maintaining the buffer at all times would be suboptimal and inefficient because it would constrain the availability and increase the cost of capital when such a result is not warranted by stress events such as credit bubbles. Moreover, *the buffer would fail to achieve its primary purpose of mitigating procyclicality as it would be held at all stages of the economic cycle.* Should the added capital charge become a *de facto* **minimum**, as we fully expect it would, the issue of procyclicality is not addressed at all, yet the costly consequences remain – that is, constrained credit availability not justified by the risk presented. The buffer just becomes a permanent contraction in bank lending.

There are other measures that may prove superior to a capital buffer in mitigating procyclicality, such as loan-to-value limits or higher risk weights that apply at higher levels of loan concentration that can be crafted to respond specifically to the stress present in the market at a given time. The ABA encourages careful consideration of the full range of prudential measures that could address stress in a more countercyclical manner.

A one-size-fits-all buffer is inappropriate in many cases and could have serious, negative unintended consequences. The application of a buffer to all credit exposures in a given jurisdiction would be overbroad and would penalize banks that manage exposures prudently. Banks vary considerably in their risk management abilities and qualities. Prudent banks should not be penalized by the actions or inactions of those that do not adhere to equally high standards. Recent experience repeatedly demonstrated material variation in the stress performance of similarly capitalized banks.

Importantly, banks could also be penalized by the actions of non-bank lenders to which the buffers would not apply. In the recent market disruptions, the subprime lending bubble was due, in great part, to the weakening of credit underwriting standards and the misalignment of risk pricing by non-bank lenders, all of which had lower capital requirements than banks. The buffer proposal would have no impact on non-bank lenders and could create serious competitive inequalities by penalizing banks for the imprudent and market-disruptive decisions of non-banks. In fact, the application of the buffer to banks, but not to non-banks, would further channel business to the non-bank sector, further exacerbating systemic risk.

The ABA strongly encourages the Committee to consider the role of non-bank lenders in the development of prudential measures intended to mitigate the effects of credit bubbles. We recognize the jurisdictional issues inherent in this consideration but it simply is inappropriate to neglect to consider the role of non-bank lenders, especially in light of recent experiences. It may be appropriate for the BCBS to coordinate its work with other international groups, such as the Financial Stability Board, that are looking at issues related to expanding the perimeter of regulation.

The need for additional buffer capital should continue to be determined on a bank-by-bank basis under Pillar 2, depending upon the business model, risk profile, risk management capabilities, and capital resources of the bank, among other relevant factors. The competitive inequities created by the buffer proposal could be addressed in part by a Pillar 2 approach that assesses on a bank-by-bank basis the business model, risk profile, risk management capabilities, capital resources, and other relevant factors of a particular bank in light of the potential for creating or exacerbating credit stresses. The use of Pillar 2 is well established in the supervisory communities represented on the Committee and allows supervisors to utilize a wider range of prudential options to address lending activities deemed imprudent. This approach would not address the issue of non-bank lenders, but it would at least lessen the likelihood that prudent banks would be penalized for the imprudent activities of their bank competitors.

It is important to note that the countercyclical capital buffer is one of **three** buffers that a banking organization would be required to hold under Basel III. Basel III also imposes a capital conservation buffer and continues the requirement for a Pillar 2 buffer through an internal capital charge. It is unclear how the buffer requirements would interact with the internal capital held by banking organizations to guard against systemic shocks. Moreover, banking organizations with robust internal capital schemes would be penalized by a buffer requirement that could duplicate its prudent internal capital allocations. Therefore, banking organizations that have substantial internal capital buffers, robust risk management and corporate governance, and adequate recovery and resolution plans should not be subject to additional capital requirements in the form of a buffer. To impose a buffer on these organizations simply penalizes them for the shortcomings of their competitors and inappropriately increases their cost of capital.

The ability of a host supervisor to set a buffer for exposures to its jurisdiction could conflict with the interests of home supervisors in maintaining a comprehensive prudential supervisory and regulatory scheme. The CP acknowledges the complex interaction of home and host supervisors in setting and implementing national buffers. The potential for competitive inequalities to arise or to be exacerbated by the ability of host supervisors to set buffers has not been explored adequately. Specifically, it is difficult for a host supervisor to assess the impact of a particular buffer requirement on banks outside of its jurisdiction. A host supervisor may also have political or competitive incentives to impose or not impose a buffer, incentives that are unrelated to credit conditions. This easily could lead to regional or national competitive inequalities among banks in different jurisdictions. Moreover, a home country regulator may not agree with the determination of a host authority to impose a buffer, given home country economic conditions. The CP does not provide for an effective mechanism to address these potential conflicts, nor does it provide a mechanism for authorities to explain and justify their buffer decisions. These mechanisms are essential to the effective functioning of a credible buffer scheme.

These issues may be best addressed by deferring actual implementation until home/host and other operational complexities are better understood and resolved. Implementation of the buffer could be explored through the existing mechanism of the colleges of supervisors. Moreover, the colleges of supervisors mechanism could serve to elaborate the respective roles of home and host supervisors under the CP.

The ability of host supervisors to set buffers also may conflict with or complicate the conduct of monetary and fiscal policies in the home jurisdiction. The imposition of a buffer can be expected to have significant impacts on monetary and fiscal policy. Therefore, coordination and communication with authorities responsible for those policies is essential. For example, the buffer would have the effect of reducing credit to prevent an over-extension of credit late in the economic cycle. However, as the economy falters, the monetary authority typically lowers interest rates and/or increases money supply in order to stimulate greater credit availability. Thus, if the buffer is not released in a timely manner, the application of higher capital standards can work in exactly the opposite direction of monetary policy efforts by contracting the supply of credit and reducing the amount of money in circulation. This means that even more stimulus might be required to achieve the same level of economic boost had no capital buffer been in place.

The CP does not discuss this important issue, which should be addressed before a buffer scheme is finalized. Moreover, the United States and a number of other jurisdictions are putting in place systemic risk authorities that should be coordinated with authorities responsible for implementing any eventual buffer mechanism.

The CP is unworkably vague as to how the buffer scheme would be implemented. The implementation of the country-by-country approach to triggering and releasing buffers, the location of the buffer, the definition and calculation of "exposures," the look-through to exposures underlying structured products, and the determination of the location of a given exposure are just a few of the operational issues that need to be elaborated.

The country-by-country approach to setting buffers raises important home-host issues discussed above. It also raises significant compliance burdens for banks, particularly those operating in multiple jurisdictions. Banks would be required to monitor the actions of multiple regulators in order to determine whether they need to maintain additional capital as a result of decisions taken to impose buffers. Alternatively and more likely, as noted above, banks may simply hold the maximum buffer amount under all conditions, a suboptimal result from a business and economic view but perhaps the best practical alternative.

The CP states that the authorities would have the right to demand that the buffer be held either at the individual legal entity level or consolidated level within their jurisdiction. Many banking organizations manage capital at the consolidated holding company level in order to promote capital management efficiency and optimal capital usage. Allowing jurisdictions to require a buffer at a sub-consolidated level would frustrate efficient capital management. There is also the potential that banks would have to hold more than one buffer for the same exposure if one jurisdiction calculates the buffer at the bank level and another calculates the buffer at the holding company level. This potential arises from the difficulty of determining the location of an exposure, as discussed below.

The definition and calculation of an "exposure" is unclear under the CP. It appears that short-term and longer-term exposures would be treated in the same manner, but there are considerable differences in the contributions of different types of exposures to credit bubbles. The contribution of a long-term loan in an overheated segment of the economy is very different from that of a short-term, undrawn commitment or a self-liquidating trade finance exposure. Yet, these exposures appear to be treated the same for purposes of the proposal. Moreover, shorter-term exposures, such as trading and derivatives exposures, change in form and amount very quickly. It is difficult to determine from the language of the CP how these exposures would be measured and at which point in time.

The "location" of an exposure can be difficult to ascertain, especially for traded positions and credit facilities under which funds may be allocated to different companies under a multinational umbrella. Traded positions can often be said to be international or at least multinational in "location." It is unclear whether the location of an exposure is the jurisdiction of its origination or the jurisdiction to which it may have been transferred. How are funds accurately located when money is fungible and funds can be on-lent or transferred in multiple transactions? It may be infeasible to look through to the geographic residency of an underlying asset or obligor when risks have been transferred and re-transferred to third parties or multiple parties through a variety of risk-sharing "tranches". If the location of a credit exposure is based on the geographic location of the originator of the credit, it could result in buffers being held in entities that do not house the exposures. This would separate the risk from the capital buffer held against the risk.

All of these issues point to significant operational issues that need to be explored fully before a buffer scheme is implemented.

We appreciate the opportunity to comment on this proposal and are available to discuss these issues in greater detail.

Respectfully submitted,

Mary Frances Monroe

Mary Frances Monroe
Vice President
Office of Regulatory Policy