

Basel III Countercyclical Capital Proposals

August 2010

Summary

- On July 16, 2010, the Basel Committee on Banking Supervision (BCBS) published a consultative document entitled “*Countercyclical Capital Buffer Proposal*” as part of the BCBS ongoing bank capital reform process
- This proposal seeks to implement a requirement for an additional minimum Tier 1 regulatory capital buffer that would be triggered by regulatory authorities from time to time during periods of excessive aggregate credit growth in the economy which is indicative of systemic risks building in the national and international banking system
- Banking institutions that fail to meet this add-on capital buffer after a 12-month implementation period would be subject to restrictions on distributions

Background

- As part of its December 2009 Basel III framework, the BCBS set forth several objectives for regulatory capital reform, including strengthening the global bank capital supervision framework by “reducing procyclicality and promoting countercyclical [capital] buffers”
- The July 2010 consultative document describes the BCBS’s countercyclical capital buffer proposal in greater detail

Countercyclical Capital Proposal

- The countercyclical capital proposal starts from the premise that periods of excessive aggregate credit growth in the broader economy are often associated with and precede the build-up of systemic risk in the banking sector
- The proposal is designed to “ensure that the banking sector in aggregate has the capital on hand to help maintain the flow of credit in the economy without its solvency being questioned”
- The proposal would impose an additional buffer range during periods of excessive aggregate credit growth to the minimum Tier 1 capital requirements normally applicable to banking institutions
 - This buffer range would be applied on a systemic basis

Countercyclical Capital Proposal (cont'd)

- The applicable regulator in the relevant jurisdiction would use macroeconomic tools in order to determine whether excessive credit growth has resulted in increased systemic risk and would then announce an associated additional Tier 1 capital buffer 12 months in advance of such add-on buffer taking effect
 - The BCBS expects such buffer to be imposed infrequently, perhaps once every 10-20 years
- A banking institution would be subject to the additional Tier 1 capital buffer (at either a consolidated level or a specific entity level) on a weighted average basis in accordance with the geographic location of its loan book and other credit exposures
- If a banking institution's capital level were to fall below the required add-on Tier 1 capital buffer and the institution fails to raise the additional capital within the proscribed phase-in period, it would then be subject to restrictions on distributions

Countercyclical Capital Proposal (cont'd)

- Inherent in the proposal is the notion of jurisdictional reciprocity whereby a banking institution's home country regulator would impose, in addition to the home country buffer, the Tier 1 capital add-on buffer implemented by other regulators to the extent that the institution in question also has foreign credit exposure
- The proposal also contemplates that the home country regulator may impose a higher buffer if it deems a particular foreign jurisdiction's buffer to be too low, but should not impose a lower buffer than the relevant foreign jurisdiction

Countercyclical Capital Proposal (cont'd)

- The proposal recognizes that identifying periods of excessive credit growth that lead to systemic risk is a difficult analytical task
- The proposal develops a methodology to do so based on the gap between the historical and actual ratio of aggregate private sector credit to GDP
- The BCBS recognizes that the credit/GDP ratio gap is not a perfect tool; the proposal stresses that, in practice, national authorities will need to use a great degree of judgment to determine the right additional Tier 1 capital buffers based on, among other variables, asset prices; funding and credit default swap rates; credit condition surveys; and real GDP growth

Countercyclical Capital Proposal (cont'd)

- More concretely, the proposed credit/GDP ratio gap analysis and resulting add-on buffer would operate in three steps:
 - by calculating the ratio of aggregate private sector credit to GDP;
 - by calculating the gap between such ratio and its historical trend; and
 - by translating the gap into an actual minimum Tier 1 capital buffer add-on

Countercyclical Capital Proposal (cont'd)

- The proposal contemplates that, if a banking institution fails to meet the add-on Tier 1 capital buffer 12 months after announcement, the institution would be restricted from paying distributions on a graduated basis in accordance with the shortfall
- Once macroeconomic conditions improve, the proposal indicates that the additional Tier 1 capital buffer would be released to allow for distributions of earnings or to absorb losses
- The release of the additional Tier 1 buffer would be implemented immediately

Implications

- The proposal would have the effect of giving the relevant national regulatory authorities another tool to reduce the supply of credit in the applicable national and international economy by increasing Tier 1 capital requirements during periods of “excessive credit growth”
 - Reducing the supply of credit is traditionally seen as the task of monetary policy as opposed to bank regulatory decision making
 - As such, regulators would be able to explicitly use capital requirements under the proposal to decrease the amount of credit available in the economy during perceived boom times in addition to more traditional monetary policy such as increasing central bank interest rates
- The ultimate success of the proposal will likely depend on the judgment by the various participants in the Basel process as to whether it is practical to actually implement given the inherent difficulty of predicting and successfully taming credit cycles

Comments

- The proposal is subject to further “calibration” by the BCBS
- Comments are due September 10, 2010