National Bank of Poland – Response to the European Commission Services consultation document regarding the proposed counter-cyclical capital buffer

Below, the NBP presents responses to relevant questions included in the Commission Services consultative paper.

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 proposal for banks to build up additional capital in good times, which would be released in periods of economic slowdown, will strengthen the long-term stability of the financial system. The counter-cyclical buffer referred to in the European Commission document is aimed at preventing excess credit growth in a given country, which would, i.a. avert the emergence of macroeconomic imbalances that could threaten financial stability. That is why, in accordance with the Basel Committee proposals, the counter-cyclical buffer, set by national competent authorities, applies to credit exposures in the territory where the creditor is located, regardless of the location of the lender.

The approach specified in paragraph 12 of the European Commission document, in line with the Basel Committee proposals, is best suited to serve the purpose and function of a counter-cyclical buffer, which is to prevent excessive credit growth in a specific market, regardless of where the lending institution is located.

Proposals A and B included in the European Commission document are based on different principles. **Proposal A** outlined in paragraph 21 suggests that in the case of branches of credit institutions located in other Member States, the level of the buffer would be set according to the procedure applying to Pillar 2 of the Basel II accord. This proposal is controversial for the following reasons:

- Firstly, the use of the counter-cyclical capital buffer within the framework of Pillar 2 would diminish the macro-prudential character of that instrument, which should be uniformly applied on a given market and not on an individual basis, which is the essence of Pillar 2. The risk of excessive credit growth and macroeconomic imbalances is a risk which exists at the level of the whole banking sector, and not only individual banks.
- Secondly, the proposal to situate the counter-cyclical capital buffer in Pillar 2 is contrary to the proposal of the Basel Committee, which in its document published on 10 September[1], clearly states that the counter-cyclical capital buffer is not a Pillar 2 approach.

[1] „*Consultative Document – Countercyclical capital buffer proposal”, Basel Committee on Banking Supervision, July 2010* – page 12.

- Thirdly, the proposal outlined in paragraph 21 applies only to branches of credit institutions, neglecting cross-border operations conducted directly, without relying on branches.
- Fourthly, the proposal gives rise to the risk that the home supervisor could set the level of a counter-cyclical capital buffer for credit exposures within the jurisdiction of the host supervisor at a lower level then recommended by the host authority. Such an approach limits the powers of the host supervisory, authority, which is responsible, within its competence, for the stability of the financial system in its jurisdiction.
- Fifthly, in the case of banks conducting cross-border activities through branches, the European Commission proposal calls for settlement by the EBA of disputes between home and host supervisors regarding the level of a counter-cyclical capital buffer. When the host supervisor determines that the level of a counter-cyclical capital buffer set by the home supervisor is insufficient, the matter would be referred to the EBA for mediation. However, it should be paragraphed out that the procedure will be time-consuming and protracted, which will increase the risk of the build-up of macroeconomic imbalances in the host country. Mediation and settlement of disputes by the EBA may delay measures undertaken in response to threats to stability and risks of macroeconomic dimension. unequivocal

The arguments listed above lead to the explicit conclusion that **proposal A in paragraph 21 does not merit further consideration**.

In turn, **proposal B**, links the buffer add-on to the jurisdiction where the credit is granted, instead of the market where the creditor is located. This approach may encourage regulatory arbitrage, as shown in the following example:

Bank X is operating in one Member State, bank Y in another. If the buffer level for an exposure originated from one of these two jurisdictions is set by the competent authority for this jurisdiction, its measures will be effective when the banks grant loans on their local markets, as the buffer level set by both competent authorities will apply to this specific credit activity. However, if both of the banks engage in cross-border lending (through a branch in another country), neither of the competent authorities would be interested in limiting credit activity on a market other than its own domestic market. It seems that proposal B refers rather to country risk, which may be regulated by existing instruments.

In this context, the analysis presented above clearly indicates that **the option based on the Basel Committee's original proposal** (paragraphs 12-20 of the Draft Consultation Document) **should be adopted.**

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 approach described in paragraphs 12-20 of the Commission Services document does not constitute a threat to the level playing field, nor will it be an incentive for potential regulatory arbitrage. This approach clearly links the level of the counter-cyclical buffer to the market where loans are granted (according to the location of establishment or residence of the creditor). If there is excessive credit growth on this market which may warrant macro-prudential concerns, the competent authority introduces a buffer set at an appropriate level, for all loans granted on that market, regardless of the lender's place of establishment. Thus, the playing field within a given jurisdiction will be level for all credit institutions.

As indicated in the response to question 1, **proposal B** does carry the risk of regulatory arbitrage.

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 should be as transparent and simple as possible. Therefore, each buffer add-on should apply to the entity that generated the credit exposure. Consequently, the counter-cyclical buffer requirement should apply at solo, sub-consolidated and consolidated level.

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.***

According to a study conducted by the Institute of International Finance, the buffers proposed by the Basel Committee will cause a considerable drop in the rate of economic growth. According to Basel Committee estimates, the consequences will not be as pronounced, and they will be compensated by benefits in the form of a lower risk of losses resulting from a financial crisis. There is no doubt, however, that each additional increase in Core Tier 1 capital will cause a respective increase in costs for banks. Therefore it can be assumed that a buffer with a size of up to 2.5% Core Tier 1 will be a factor dampening the activity of banks. If it should turn out that the buffer, even at maximum level, does not produce desired results, it would be possible to repeat the calibration and increase the maximum level.

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.***

Banks publicly disclose information concerning the level and structure of their capital, as well as data regarding capital adequacy. This information is crucial for market discipline and the security of individual banks, therefore it should be fully accessible and straightforward. The information should thus be published by banks (the buffer's share in a bank's capital), as well as competent authorities (the buffer level for a given country).

The European Systemic Risk Board may contribute to increasing the transparency of decisions taken by competent authorities regarding the level of the counter-cyclical buffer by developing the general principles of macro-prudential policy (e.g. the frequency of reviews by national authorities) including guidelines for setting the buffer level. A clear and comprehensive justification issued by competent authorities on their decisions should contribute to a better understanding of the essence of the counter-cyclical buffer and reasons for changes to the buffer level, which should enhance the effectiveness of the buffer as a macro-prudential instrument.

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?

This is a task for the EBA, especially in relation to technical standards as regards supervisory cooperation and the exchange of information. These standards may include e.g. a set of information to be disclosed to the public when announcing a decision on setting the level of the counter-cyclical buffer[2].

(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?

The ESRB should focus on monitoring systemic risks, identifying risk factors and prioritising threats. By issuing recommendations and warnings the ESRB should indicate measures to be undertaken by the recipients of recommendations, and then monitor the implementation of these measures by competent authorities of Member States. The buffer level should be set by competent national authorities. On the other hand, decisions taken by national authorities should be coherent. Thus the ESRB should engage in reviewing the decisions of national authorities and how they relate to each other.

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

This question may be interpreted in two ways:

1. Should the EBA monitor the implementation of the binding buffer level by individual banks? This is not a task for the EBA. It should be the responsibility of national supervisors, who should ensure that buffer decisions are implemented in their jurisdictions.

2. Should the EBA be involved in harmonising the process of introducing the counter-cyclical buffer as an instrument used by national competent authorities? Such a role could include the development of standards regarding the process of setting the buffer level, communication and disclosure of decisions.

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

The ESRB should focus on monitoring systemic risks, identifying risk factors and prioritising threats. By issuing recommendations and warnings the ESRB should indicate measures to be undertaken by the recipients of recommendations, and then monitor the implementation of these measures by competent authorities of Member States. This implies that the ESRB could establish the general criteria for sound decision-making in the setting of the counter-cyclical buffer. In addition, the ESRB in its recommendations could indicate the need to impose a buffer. In turn, the EBA should focus on technical matters, standards and their implementaton by national authorities.

[2] An example of such a standard in practiced by CEBS was the standardised form used for publication of the results of stress tests in the summer of 2010.

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

According to the Basel Committee's press release of 12 September 2010, common equity (Core Tier 1 capital) or other fully loss-absorbing capital should be used to meet the counter-cyclical buffer requirement. In order to ensure the buffer's effectiveness, it should be covered by Core Tier 1 capital. It is worth noting that the method of aggregating the two buffers (conservation buffer and counter-cyclical buffer) proposed by the Basel Committee requires that both be covered by the same type of capital instrument, i.e. Core Tier 1.

The counter-cyclical buffer will affect banks by increasing the cost of capital for lending. For a given buffer level (e.g. 1%), the better the quality of capital to be set aside for covering the buffer, the higher the cost of capital born by a bank for new lending. As the maximum level of the counter-cyclical buffer is limited, only the highest quality of capital (Core Tier 1) should be eligible for covering the buffer requirement. This will allow competent authorities to adequately respond in the broadest extent to imbalances on the credit market (excess credit growth).

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

If the counter-cyclical buffer is to prevent excessive credit growth, it must be based on the nominal value of exposures, not risk weighted assets. If risk weights are taken into account, low-weight exposures would have a marginal impact on the imposition of a buffer. However, certain types of loans with a low risk weight (e.g. residential mortgages) may contribute to the emergence of macroeconomic imbalances if they are granted at excessive levels.

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.*

As a rule, the counter-cyclical buffer should be uniformly and universally applied towards all banks in a given country, applying to all exposures. Any other option will limit exposures covered by the buffer, and promote those which are not covered. Furthermore, defining the exposures not covered by the buffer will be an incentive to manipulate the classification of exposures by banks, in order to achieve the lowest possible buffer level for their balance sheet. Only the uniform use of a buffer applying to all exposures will be, as an instrument of macro-prudential policy, a proper response to rising macroeconomic risks. This type of instrument, based on maximum simplicity and transparency, will reduce the risk of regulatory arbitrage and will not distort competition between banks, and will not become an instrument of manual credit allocation in the economy.

However, competent national authorities should have the possibility of applying exemptions from the general rule by imposing a buffer for only those types of exposures which in a given situation, may lead to the destabilisation of the financial market and macroeconomic imbalances. Such a situation could occur, for example, when the only category of loans determined to be excessively growing would be FX mortgage loans. Excessive growth in this category could lead to speculative bubbles on the markets for certain assets, weaken the effectiveness of monetary policy and constitute an additional risk factor for the stability of financial markets and the economy.

The application of the counter-cyclical buffer only for specific exposures would be conditioned by the national competent authority presenting a rationale to the ESRB justifying the exemption from general rule.

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.***

It seems that the competent securities market authority should be equipped with the same instruments as in the case of banking authorities. This would minimise the risk of cross-sectoral regulatory and supervisory arbitrage.