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.

We consider that the approach of the Basel Committee summarized in paragraph 12 has several advantages over the other two approaches (A and B).

In what regards proposal B, computing buffers for cross-border banking groups based on the jurisdiction from where the credit is granted would be easier to implement, as this approach would not require collecting data on the location of counterparts. However, this approach would severely undermine the level-playing field between banks granting credit in jurisdictions where they have an establishment (either a branch or via a legal entity) and those that are not established in that same jurisdiction through a branch or a legal entity. Taking into account the example in paragraph 24, if a “bank with its head office in France (the home Member State) grants credits from a branch in Belgium to creditors located in Belgium, France and Germany, the add-on for all those credits would be that set by the Belgian authority”. In this case, a bank without establishments in Belgium granting credit to Belgian borrowers would not have to build the buffer add-on reflecting the excessive build up of risks in this country, even though it was directly contributing to this situation. This would give banks in such situation a significant competitive advantage. Moreover, with this approach the objectives of the buffer would not be met, as institutions without establishments in Belgium would have the incentives to continue to grant credit to that economy even if the buffer add-on was active, thus leading to regulatory arbitrage.

Approach A, which considers leaving the countercyclical buffer entirely to the discretion of home supervisors, would lead to even more challenging level-playing field issues and the ensuing regulatory arbitrage issue. Furthermore, possible disputes between national supervisors might be frequent, even considering EBA’s guidance and dispute settlement roles. Indeed, setting up the buffer and determining its level will rely heavily on judgement, thus making it possibly difficult to reach an agreement between home and host supervisors in all situations. Besides, the possibility of imposing buffers lower than those recommended by the authorities in the host Member States could hamper the goals of the countercyclical capital buffer.

All in all, even though the proposal of the Basel Committee is more demanding in terms of data requirements, it has substantial advantages over the other two approaches in what concerns its ability to mitigate the build up of imbalances through the credit cycle. Nevertheless, the possibility of setting additional bank-specific countercyclical add-ons on top of the jurisdiction specific buffers under a Pillar two approach is a very relevant
hypothesis, which should be explicitly mentioned in the proposal outlined in paragraph 12. In fact, the Basel Committee approach does not take into account different attitudes towards risk among financial institutions. For instance, a bank that has taken less risk, not only in credit granting but also in other activities, during a period of building up of risks and/or imbalances at the macro level may suffer penalties through the imposition of the countercyclical capital buffer. We consider that a sound and effective macroprudential policy should be anchored on solid mechanism design principles. In particular, regulation should address the incentives of each individual institution in a way that promotes the social optimum and minimizes welfare losses. Macroprudential tools should ensure that the correct incentives are provided, so that institutions take into account the externalities they generate, most notably in terms of systemic risk. Hence, macroprudential policy would ideally rely on the interaction of macro and micro-based instruments, as discussed by Brunnermeier et al (2009), for instance. Given this, the countercyclical capital buffer should not be blind as to the origin of the imbalances generated and should be designed in a way that ensures that the financial institutions with more responsibilities in the build up of aggregate risks bear a higher cost. Otherwise, this countercyclical regulation may have as an unintended effect an increase in the average risk taken by financial institutions. In other words, institutions with safer activities when faced with an add-on that is based on the average risk of its competitors would have the incentives to take more risk.

Finally, it should be acknowledged that there are several other macroprudential tools (some of which based on microprudential instruments), which can be used together with the countercyclical buffer.

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?

As discussed in our answer to the previous question, we consider that both approaches A and B could lead to severe regulatory arbitrage strategies. If approach B was adopted, banks without establishments in jurisdictions where the buffer add-on is active would have a strong competitive advantage in granting credit to borrowers in these jurisdictions. In addition, in approach A the home supervisors could favour banking groups with head office in their jurisdictions if they were allowed to hold buffers lower than those recommended by the authorities in the host Member States, thus also generating distortions in the level-playing field.

Furthermore, the Basel Committee proposal may also be subject to potential leakages and regulatory arbitrage. In fact, this proposal envisages an extremely challenging degree of international cooperation, based on heavy data collection and analysis, and strong commitments towards transparency. Supervisory authorities would need to be fully coordinated worldwide and the scope of application would have to be global. As this scenario may be unrealistic, we remain concerned about the distortions and leakages generated by this proposal which, in some
circumstances, may even affect credit aggregates and their information content for economic analysis. Again, we refer to the discussion of Brunnermeier et al (2009) on the boundary problem in financial regulation, which is of extreme importance for the current proposal.

The definition of credit aggregates may also be a very important issue in this context. The Basel Committee proposal is based on the principle that the aggregates considered should be as broad as possible. In this domain, a key challenge is related to the possibility of circumventing behaviours by financial institutions, which may ultimately lead to serious distortions in credit aggregates. Given the boundary problem in financial regulation, there may be arbitrage between regulated and unregulated financial institutions, resident and non-resident lenders, or the possibility of resident non-financial corporations establishing finance vehicles in different jurisdictions, just to mention a few. A very special problem may arise, for instance, in credit granted to cross-border to non-financial firms.

Further, in order to mitigate regulatory arbitrage, it should be stressed the importance of evaluating the different dimensions of credit aggregates (e.g. considering credit granted by residents versus non-residents, credit granted by different types of financial institutions or using different financial instruments), specially taking into account the difficulties arising from the cross-border implementation of this buffer.

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?

Even though there may be some costs resulting from the imposition of the buffer requirement at solo, sub-consolidated and consolidated basis simultaneously, this approach is entirely in line with the Capital Requirements Directive (CRD). In a case-by-case analysis, supervisors could eventually be allowed to waive the buffer requirements on a solo basis, as long as the buffer is always met at the consolidated level and the conditions foreseen in the Article 69(1) and 69(2) of the CRD are also fulfilled. Nonetheless, we consider that the principle of simultaneous application at solo, sub-consolidated and consolidated level should prevail.

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.

The definition of a 2.5% ceiling could benefit from further quantitative analysis, as the Basel Committee documents released so far do not provide sufficient details on the grounds for the definition of the ceiling. Therefore, we support that further exercises should be conducted in order to evaluate in more depth the costs and benefits of imposing a ceiling of 2.5%.
Nevertheless, under Pillar 2 national authorities could always impose additional capital requirements on specific institutions, either from a pure micro-prudential point of view or aiming at curbing the build up of risks at an aggregate level. Institution specific additional requirements can be specifically targeted at those institutions that contributed more to the build up of risks.

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.

We agree that the decisions regarding the countercyclical buffer should always be transparent and clearly communicated to the markets, in order to reduce uncertainty and anchor the expectations of agents on future developments. Taking the conduct of monetary policy as an example, the setting up of the countercyclical buffer does not need to follow a mechanical rule. Rather, its aim should be well understood and the authorities intentions predictable to the extent possible. To this end, an overall and encompassing review of macro-prudential risks based on a comprehensive set of information should be undertaken and conveyed to the market in a consistent way. In this respect, the ESRB can have a role in ensuring the level-playing across different jurisdictions.

Even though the supervisory authority or central bank should decide which indicators should be used to activate or release the buffer, the ESRB can have a coordinating role in promoting the harmonization of methodologies for the implementation of the buffer. Thus, the ESRB will ultimately ensure the necessary consistency and coordination of macroprudential policy in the EU. Nevertheless, the decision should always be based on judgement taking into consideration a broad and encompassing range of indicators. Further, as mentioned in point 20 of the consultative document decisions should be taken at the level of national authorities.

Hence, the public disclosure of buffer decisions needs to be decided in close articulation between the ESRB and national authorities, as the latter always have more detailed information on the building up of risks in their respective jurisdictions and are more aware of the consequences of activating and releasing the buffer in specific circumstances.

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?

(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?

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

(d) What are your views on the possible interaction between the respective roles of the ESRB and the EBA?
Both the ESRB and EBA should work closely to develop principles and technical standards that ensure the consistency of buffer decisions within the EU. The mechanisms for information exchange should be rooted in the cooperation framework between these authorities envisaged in the new European regulatory setting.

As discussed in the answer to Question 5, we consider that the decision to activate and release the buffer should be ultimately on the hands of national authorities, with the ESRB playing a decisive role in guaranteeing the cooperation between different jurisdictions. In this sense, the ESRB should have the responsibility, together with national authorities, to accompany at the European level the need to activate or release the buffer. Besides, EBA should ensure that the buffer decisions are implemented in a consistent way.

All in all, the ESRB, the EBA and the national authorities’ roles regarding the countercyclical capital buffer are deeply intertwined, requiring a high level of close and permanent cooperation, preventing diverging approaches and improving the functioning of the internal market. This cooperation can nevertheless be challenging in many dimensions.

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

We recognize that Core Tier 1 capital instruments have the strongest loss-absorbing capacity. Credit institutions will have to substantially reinforce their core capital to meet the new Basel III capital requirements, namely the Core Tier 1 capital ratio and the capital conservation buffer, thus making them much more resilient to adverse shocks. Given the additional and more stringent requirements imposed on the computation of future Core Tier 1 capital, we see merits in considering additional forms of capital instruments to meet the countercyclical capital buffer, making reference to the on-going discussions at the level of the Basel Committee regarding contingent debt eligible as capital for regulatory purposes.

As the issuance by a national authority of a decision to release of the buffer implies, primarily, a need to absorb actual losses, we consider that these additional capital instruments should be regulatory capital from inception, even if only eligible for Tier 2 regulatory capital, with the possibility to convert it into a more loss absorbent type of capital instruments (without prejudice of other decisions institutions may wish to take, such as a decision to increase capital). We consider that such additional capital instruments should be regulatory capital, because we understand that the countercyclical buffer will be a regulatory requirement translated into higher capital ratios.

However, another issue needs to be taken into account, namely the fact that the release of the countercyclical buffer may result from lower risk (a national authority considering that the buffer should x% instead of y%, being the former lower than the latter and, in the limit, equal to 0%) reflecting the authorities’ view that the risks are increasing at a slower pace and/or that the losses did not, in fact, materialise to the same extent as envisaged at an earlier stage.
Hence, the additional instruments to cover this buffer requirement should be such that allow for their redemption (callable) or for the increase of risks, thus allowing the fulfilment of regulatory capital ratios and ensuring that objective of maintaining credit flows to the economy in periods on financial stress is met.

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

Assuming that the question is related to weighing cross-border countercyclical buffers, we broadly agree with the proposal set out in the Basel Committee Consultation Document on the Countercyclical Capital Buffer, which suggests that the exposures should be weighed according to their nominal value in different jurisdictions (and not according to risk factors), even though the buffer add-on is built as a percentage of risk weighted assets. For instance, mortgage loans have relatively low risk factors, even though housing market bubbles are frequently underlying the building up of system-wide risk. Hence, if such exposures were weighed according to their respective credit risk factor, it would be harder to ensure that the countercyclical capital buffer was useful to curb risk-taking strategies in the financial system.

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.

Even though it is not clear which types of exposures are considered in this question, we think that the buffer should potentially be applied to the broadest definition of exposures possible. However, if the build up of risks is concentrated in a very specific type of exposure (e.g., real estate loans), the possibility of imposing countercyclical buffer specifically targeted at such exposures should be considered. This approach would have the advantage of directly addressing the sources of risk, hinging more acutely on the institutions with more significant exposures to that specific source of systemic risk.

Further, it could also be possible not to restrict the scope to debt exposures. For instance, direct equity exposures may hide debt exposures through finance vehicles or represent residual claims on pools of debt exposures (e.g., the equity tranche of securitisation operations).

All in all, a significant degree of flexibility is warranted in the implementation of this buffer.

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.

We consider that investment firms should in principle be excluded from this buffer, unless they engage in credit operations that are similar to those of credit institutions as regards their nature, risk and maturity. Further, we
stress the need to permanently assess possible circumventing strategies related to regulatory arbitrage involving these investment firms.

11. Do you have other comments or suggestions?

There are several issues in the Basel Committee proposal that deserve further discussion. More specifically, Banco de Portugal has some specific comments and suggestions on the following issues:

i) Measurement of credit to GDP long term trend and deviations;

ii) Measurement of credit to GDP long term trend in financial systems at different stages of development;

iii) 12-month pre-announcement period;

iv) Signalling the release of the buffer; and

v) Interaction with monetary policy.

i) Measurement of credit to GDP long term trend and deviations

The proposal suggests the use of the Hodrick-Prescott filter to estimate the trend of the credit-to-GDP ratio. However, it should be mentioned that this filter suffers from several statistical drawbacks. Firstly, the trend depends on the choice of the parameter \( \lambda \). The proposal suggests using \( \lambda=400,000 \), what may be regarded by some experts as too high, as the smoothing parameter used for quarterly data is usually \( \lambda=1,600 \)\(^1\). Using such a high parameter implies that the trend becomes much smoother (almost linear) than if a smaller parameter was used instead. This said, any small movement away from the long-term trend will be reflected in the cyclical component. Moreover, it becomes harder to capture structural changes in the credit-to-GDP trend. For example, if in some countries the credit to GDP ratio becomes structurally lower after the current financial crisis, it will remain below the trend for a much longer period than if a smaller parameter was chosen. Secondly, the H-P filter is usually not very accurate in the beginning and end of the sample period, as it gives more weight to these observations. Hence, potential revisions in the more recent data or short-term temporary movements away from the trend may affect the results. This uncertainty is specially marked in turning points of the cycle, given that as new information becomes available the results may change significantly\(^2\). This latter issue reinforces the argument put forth on the Basel Committee consultation document about not relying on a single variable to signal the release of the buffer.

Taking into account these statistical problems, we suggest that the implementation proposal could explicitly mention the need to compute long-term trends using different values for \( \lambda \) and using different filters which are also available in standard econometric packages, such as the Bandpass or Kalman filters. This sensitivity analysis is crucial to anchor the implementation of the countercyclical buffer add-on.


In addition, we consider that the guidelines should also refer the possibility of computing the credit to GDP ratio for different sectors, in order to identify the build-up of specific vulnerabilities (e.g., mortgages, loans to real estate and construction firms). Moreover, the evolution of GDP components should also be monitored, in order to evaluate whether credit growth is being driven by an expansion of consumption or investment, for instance. Another important dimension of this analysis is to monitor the building up of external imbalances fuelled by excessive credit growth.

Furthermore, as acknowledged in the Basel Committee consultation document, the analysis of the credit to GDP trend needs to be complemented with other indicators. We suggest that this analysis may also be complemented using other methodologies. One possibility is to study multivariate relationships between credit and other variables, as GDP is not the sole determinant of credit granted to the economy. By establishing a statistical (possibly cointegrating) long-run equilibrium, it becomes possible to analyse deviations as signals of excessive credit growth. Another possibility is to use non-parametric quantile regressions to identify periods of excessive credit growth.\footnote{See Machado, J. F. and J. Sousa (2006), "Identifying asset price booms and busts with quantile regressions", Banco de Portugal Working Paper No. 8/2006.}

ii) Measurement of credit to GDP long term trend in financial systems at different stages of development

We consider that the proposal to compute the credit to GDP ratio does not fully take into account countries at different stages of financial development. For example, for an emerging market economy the credit to GDP ratio will necessarily grow above trend as it becomes more financially developed. This will be more significant for economies departing from very low levels of this ratio. Hence, even if GDP is also growing significantly, credit may increase at a much faster pace if the starting point was very low in absolute terms. In this scenario, it is possible that the countercyclical buffer can undermine growth prospects in some countries. Moreover, if both credit and GDP are increasing in an unsustainable trend, the credit to GDP ratio may fail to adequately capture the building up of imbalances. These arguments reinforce the need for a judgment-based approach and the importance of evaluating other indicators before a decision is made as regards the building-up of the buffer.

iii) 12-month preannouncement period

Even though we understand the reasons to define a reasonably long period to allow banks to adjust their capital to the additional requirements in certain phases of the credit cycle, we consider that the proposal should include the possibility of allowing supervisors to establish shorter preannouncement periods and/or allowing for a gradual capital increase during the 12-month period. This may be relevant in situations of extremely fast credit growth. It should also be considered that the economic situation may change rapidly, thus making inappropriate the creation of the buffer after 12-months. During this 12-month period, financial institutions may also be able to engage into
circumventing behaviours. Further, we believe that the proposal would benefit from a more detailed justification of the choice of a 12-month period.

Different time lags in the release of GDP data across different jurisdictions should also be taken into account.

iv) Signalling the release of the buffer

As acknowledged in the Basel Committee consultation document, the evidence concerning which indicators perform better in signalling the release of the buffer is rather mixed. Hence, in order to avoid excessive discretion, we consider that more work needs to be conducted to improve this part of the proposal.

Additionally it should be mentioned that although the proposal incorporates more guidance regarding the prompt release of the buffer in times of stress, it is rather silent in relation to such release when system-wide risks recede or when losses supposed to be covered by such buffer do not materialise. This issue cannot be dissociated from another that relates to an institution capital planning and to the composition of this buffer, namely which elements/instruments can comprise the buffer and which characteristics should they have. These topics need further development in the final proposal, the last one being closely linked with the proposals on regulatory capital.

v) Interaction with monetary policy

We consider that more analysis needs to be done on the interaction between this macroprudential policy tool and other macroeconomic policies, most notably monetary policy. In fact, the countercyclical capital buffer may have implications in the transmission mechanism and effectiveness of monetary policy. Besides, some of the vulnerabilities arising from excessive credit growth may also be addressed with monetary policy tools. This issue should be taken into account when deciding to impose the countercyclical buffer add-on. Indeed, the most recent literature points to the superiority of coordinated macroprudential and monetary policies, rather than the pursuit of independent goals. In this sense, non-coordinated policies would deliver second best results.

Final remarks

As stated in Drehman et al (2010), “any effective scheme would need to have a number of desirable features. First, it would identify the correct timing for the accumulation and release of the capital buffer. This means correctly identifying good and bad times. Second, it would ensure that the size of the buffer built up in good times is sufficiently large to absorb losses without triggering serious strains. Third, it would be robust to regulatory arbitrage, including manipulation. Fourth, it would be enforceable internationally. Fifth, it would be as rule-based as possible, acting as an automatic stabiliser. In particular, this would ease the pressure on prudential authorities
to refrain from taking restrictive measures in good times. Sixth, it should have a low cost of implementation. Finally, it would be simple and transparent.\textsuperscript{4}

We do not consider that the current proposal meets all these desirable features, most notably in what concerns the possibility of regulatory arbitrage, the international enforceability, the low cost of implementation and its simple nature. The proposal also fails to take into account different attitudes towards risk among financial institutions. Indeed, a sound and effective macroprudential policy should ensure that the correct incentives are provided at the institution level, so that financial institutions take into account the negative externalities they generate, thus achieving a solution closer to the social optimum. Otherwise, this countercyclical regulation may have as a unintended effect an increase in the average risk taken by financial institutions.

Moreover, potential leakages and regulatory arbitrage are a relevant issue to be considered. The current proposal envisages an extremely challenging degree of international cooperation, based on heavy data collection and analysis, and strong commitments towards transparency.

References

