

Response to FSA Consultation Paper 09/30 - Capital Planning Buffers

1 Introduction

This response is made by Volterra Consulting Ltd. Volterra is an economics consultancy. Over the past 5 years an increasing part of our business has been advising financial services clients in the area of stress testing, initially under the requirements of Basel II and more recently with regard to provisioning outcomes. As such we are well placed to understand the problems of current systems, either with respect to provisions or capital, and particularly those related to a consideration of economic events. Our work has predominantly been in the area of retail credit risk, but our interests and expertise within the company mean we have a strong understanding of the problems of current approaches to market risk and corporate risk.

We broadly welcome the clarification of the role of capital planning buffers and believe that explicitly dividing Pillar II capital into two parts will create greater certainty for firms regarding which element of it may be drawn down in a recession and which may not.

2 Responses to Questions

Q1: Do you agree with our market failure analysis and our summary cost-benefit analysis?

We agree that the issues identified in the market failure analysis should be addressed and do not have specific comments to make on the cost-benefit analysis.

Q2: Do you agree that breaking the link between GENPRU 1.2.26 and the capital planning buffer will make it clearer to firms, their boards and their auditors that the CPB is designed to be drawn down during adverse external circumstances?

We agree that the breaking the link between GENPRU 1.2.26 and the CPB in the guidance issued to firms will improve the clarity of the principle that the CPB can be drawn down in adverse external circumstances. However, the FSA may need to go further in providing guidance on the circumstances in which permission to draw down the CPB will be granted. This would enable firms, their boards and their auditors to have confidence that drawing down the CPB will be possible and to plan accordingly. The success of the framework will be dependent on firms incorporating the ability to draw down the CBP in their capital planning processes.

Q3: Do you have any comments on our approach regarding the use, monitoring and rebuilding of capital planning buffers?

Communication with the market

One of the most important features of the CPB framework will be ensuring that good communication with the market is maintained to ensure that there is no loss of confidence resulting from firms legitimately using up their capital planning buffers. There are a number of aspects to this.

Firstly, there is a danger that the market will interpret a decision by a specific firm to begin using their CPB as being a sign of weakness. This is essentially a coordination problem, in that whilst it is in every firm's interest for CPBs to be used up in a recession to avoid a scramble for capital in the market place it is in no firm's interest to be the first to seek to do so, lest it be perceived as being weak. The FSA could alleviate this problem by co-ordinating use of CPBs by making a public statement that, in general terms, it was appropriate to start using up the CPBs. This need not necessarily preclude the FSA from issuing individual capital guidance on the use of CPBs to specific firms, but would help to create an environment in which using the buffer would be considered acceptable.

Secondly, as firms' capital ratios are expressed as a percentage of Pillar I Risk Weighted Assets, any drawing down of CPBs would be reflected in lower capital ratios. This may well be interpreted by the market as being a sign of weakness rather than firms acting prudently and in line with regulatory guidance. There are a number of ways that this could be dealt with. One option is to enhance disclosure requirements by requiring firms to disclose information regarding the amount to which they are drawing down or are allowed to draw down CPBs. Whilst some firms may object to this type of information being placed in the public domain it would allow market analysts to make more informed assessments about capital positions. An alternative approach would be to include Pillar II capital requirements in the denominator of the capital ratios or to exclude amounts in the CPB from the numerator. This would be a significant change from current practice and would require international agreement. The advantage of such an approach is that as CPBs were drawn down in line with regulatory guidance the CPBs would not fall. A potential concern may be that internationally some regulators may try to game the system by claiming that their firms are better capitalised than in fact the case, and in any event country to country comparisons of capital ratios would be made harder. We therefore consider that enhanced disclosure would be the most plausible solution in the first instance.

Interaction of Micro-prudential and Macro-prudential Regulation

A key area which is touched on in the consultation paper is that capital planning buffers will have to interact with any new macro-prudential regulation which may be introduced. A significant number of proposals have been put forward by the Bank of England and the Basel Committee of Banking Supervision although there is not yet a firm international consensus on how to proceed.

Furthermore, the FSA noted in a recent Feedback Statement¹ in reply to responses received to a question on how to address the problem of procyclicality through counter-cyclical reserves or buffers that,

“Pillar 2 does not build up a system-wide precautionary buffer in the way envisaged by these approaches. The idiosyncratic capital planning buffer currently identified under Pillar 2 is a necessary but not sufficient tool to achieve the outcomes of the FSA’s prudential regime. Moreover, there is a risk that a Pillar 2 system-wide buffer may deliver inconsistent outcomes across national jurisdictions depending on their different applications of Pillar 2, which is undesirable”

To date, we do not feel that there has been sufficient clarity on what the purpose of a second pot of money in addition to the CPB would be. If CPBs are introduced which genuinely are sufficient to absorb losses and any remaining procyclicality in capital requirements, to the extent that firms can maintain funds available for lending at pre-recession rates during an economic downturn, then it is not obvious what purpose further buffers would serve. There are areas where it may be legitimate to apply macro-prudential regulation, for example in respect of ‘systemically important institutions’, but the purpose of these should be explicitly stated and their interaction with Pillar II CPBs should be assessed. It will be necessary to review the CPB regime in the light of any macro-prudential regulation that is ultimately introduced by the Bank of England or other authorities.

Q4: Do you understand our proposed clarification that we may specify elements of the CPB or ICG that should be held in particular forms of capital?

We agree that it is appropriate for the FSA to specify that the CPB should be held in particular forms of capital to ensure that firms will be able to absorb losses and meet capital requirements in a time of economic stress. In the recent market turmoil losses diminished firms’ stock of Core Tier 1 capital, and so to the extent that the CPB is required to absorb future losses it should be held in the form of Core Tier 1 capital. To the extent that the CPB is required to cover procyclic movements in capital requirements, the CPB should be held in the form of capital for which increased requirements are anticipated.

In respect of other ICG, it remains appropriate for the FSA to specify the form of capital that should be held on a firm by firm basis.

¹ http://www.fsa.gov.uk/pubs/discussion/fs09_03.pdf