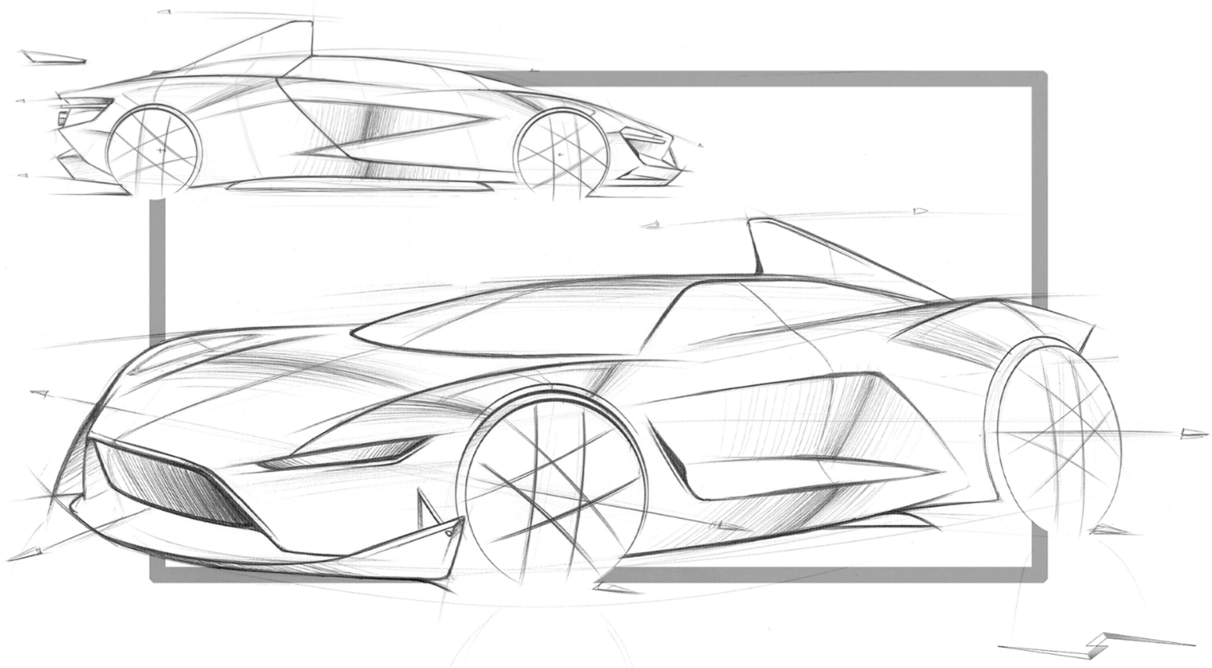
Bufferati: a simpler alternative?



Context

Sam Woods' recent Bufferati speech on a radically simpler approach to capital buffers has sparked discussion in financial circles about the feasibility of such an approach, and added fuel to the longstanding discussion on the current regime's suitability and effectiveness.

In this note, we set out some of the key aspects of Sam's proposed approach and offer our initial views on whether it could address the shortcomings in the current regime.

We understand that the speech seeks to spark a discussion and debate on the appropriateness of the current capital stack and its underlying complexity and generate ideas on how to introduce meaningful reform. Sam's views are not in the nature of formal proposals at this stage and we are a long time off from them, or a version of them, becoming reality in the near future.

Focusing on some of the key characteristics of the Bufferati regime, our view is that it offers neither a radical nor simpler alternative. In particular, the Bufferati regime could introduce additional complexities while decreasing the transparency in the system, leading to potentially sub-optimal regulatory outcomes and have unintended consequences for some market participants.

Let us discuss each key component of the Bufferati framework in a bit more detail.

Single Calibrated Buffer

The core characteristic of the Bufferati regime is that there will be a single calibrated buffer, sitting above a low regulatory minimum capital requirement that replaces the existing suite of capital buffers in addition to Pillar 1 and Pillar 2A. The single buffer will be calibrated based on a combination of firm-specific and macroeconomic considerations.

While the firm-specific portion of the buffer would be based on the risk exposure of the firm's business, blending with a macro-economic element may not make the riskiness of an individual firm necessarily transparent.

Under the Bufferati regime, all requirements would need to be met with the highest quality capital – Core Equity Tier 1 (CET1). Even without implementing this as a requirement, the amount of CET1 Firms would have to hold as a percentage of the total would increase significantly under the Bufferati regime, as all buffers in the current regime, as well as the majority of the regulatory minimum requirement, must be met with CET1.

In terms of responding to this shift, Firms could either increase the quantum of their CET1 instruments that fall within the definition of Article 26 of the Capital Requirements Regulation (CRR); or, decrease the size of deductions under Article 36. Both approaches have a number of ramifications.

Increase quantum of CET1 instruments	Decrease size of deductions to CET1 instruments
• Securing funds via equity rather than debt would be costly for firms. This will no doubt enhance the loss-absorbing capacity of Firms and the UK's financial system, but firms would have to bear a greater operational and financial burden; • Firms may engage in more frequent financial audits, so as to recognise any realised / unrealised profits as CET1 more frequently. This would in turn drive costs up for firms – especially for smaller Firms; and • Firms that currently use Additional Tier 1 (AT1) and / or Tier 2 instruments to meet part of their requirements would need to find a way to convert these to CET1 – a costly exercise	• Firms, in general, might become more risk-averse – as all losses are fully deductible (without needing a financial audit); and • Firms might be discouraged from lending to "vulnerable sectors" and/or raise their interest rates for loans that are sold to such "higher risk" institutions / customers to offset the additional costs w.r.t to converting tier 2 instruments into tier 1; and • Legacy Firms could potentially accelerate the end of "free" banking for retail customers including SME, by following the neo-lenders

Taken together, these additional costs of a CET1-only regime could have the unintended consequence of reducing lending and competition in the system.

The key question here is whether Firms, and in particular smaller lenders, can maintain their competitive edge or even continue to operate amidst such changes, and how the additional costs of regulatory change fit with the PRA's clear intention of making the UK market more attractive.

Low Minimum Capital Requirement & "Ladder of intervention"

The new conceptual buffer will replace all thresholds, triggers, and cliff-edges with a judgement-based *'ladder of intervention'*. This means that there would be no automatic consequences to dipping into the buffer, or indeed the minimum capital requirements. If that happened, firms would be expected to have a plan to replenish their capital supply. What needs to be in that plan could vary widely depending on the firm-specific and/or macroeconomic circumstances which had led to the firm entering its buffer, including whether some of the buffers had already been released by the authorities.

As a result, firms could afford to be more relaxed in their approach to the risk of breaching regulatory requirements. This can be seen as a positive step towards making compliance with the regulatory regime less burdensome but it could also lead to issues of moral hazard, similar to the events that played a central role in the Global Financial Crisis (GFC), in the absence of tangible consequences. Having to have a plan to replenish their stocks of capital when buffers are entered is a feature of the current regime Firms have to comply with.

Increasing the portion of overall capital requirements that is in buffer form improves the toolkit available to regulators during a stress as the size of the impact on the system from using those tools could be materially larger. Moving towards more of a judgement-based approach for intervention would also introduce additional flexibility that may be required during times of stress.

However, the lack of transparency that comes with a judgement-based ladder of intervention, as well as the potential return of damaging moral hazard in the system, could lead to worse outcomes overall.

The role of Stress Testing

Stress testing would continue to be used to determine capital requirements but under the Bufferati regime it would not resemble the current annual cyclical approach, where a bank's ability to keep its capital levels above a pre-set hurdle rate in a severe but plausible economic downturn is tested. Instead, stress testing in the Bufferati regime would involve numerous different scenarios, an approach that more resembles the current insurance stress testing approach. Ultimately, this move could mean that the system moves towards standardised risk weights and relies on stress testing to deliver the sophistication which currently comes from the internal ratings-based and other internal stress testing approaches.

The use of the standardised approach can be expected to reduce the cost of regulation on firms and can be seen as another benefit of the concept, however, significantly increasing the number of scenarios could increase the operational burden on Firms, particularly smaller firms. It's also likely that moving to a uniform standardised approach could be unpopular amongst the large and medium sized Firms which choose not to use it due to its lack of sophistication and risk sensitivity.

A radical and simple(r) alternative?

While the Bufferati regime would make some aspects of the capital regime more straightforward, as already pointed out, it could also present some new challenges and complexities that firms would have to contend with.

- Firstly, and most importantly, **the underlying drivers of requirements under the Bufferati regime are largely left unchanged**. A key consistency between the current and Bufferati regimes is the fact that requirements in each are based on a mix of risk-weighted and leverage-based approaches. Minimum and buffer requirements are simply a function of these underlying measures. Our view is that the complexity in the current regime comes mainly from the calculation of Risk-Weighted Assets (RWAs) and leverage exposure, rather than understanding the different buffer components. Adopting the Bufferati regime would replace multiple 'percentage of RWAs' numbers with two 'percentage of RWAs' numbers but it doesn't address the underlying RWA-related complexities – interpretation, methodologies, capabilities – that firms face under the current regime. Moving to a standardised-only approach would not address this issue either and could be unpopular for the reasons set out previously.

- Shifting from the multiple 'percentage of RWAs' numbers to two 'percentage of RWAs' numbers introduces a new layer of complexity for firms as **the link between underlying RWAs and minimum and buffer requirements becomes less transparent**. Under the current regime, the minimum requirements, composed of Pillar 1 and Pillar 2A, are straightforward to understand based on the underlying RWAs. Pillar 1 requirements relate to unexpected losses across credit, market and operational risks, while Pillar 2A requirements relate to risks not adequately captured in Pillar 1. Moving to a minimum requirement under the Bufferati regime that is below this level breaks the current link between RWAs and minimum requirements. Firms' ability to clearly understand why they have to hold a certain amount of capital is key to an effective regime.

- **This lack of transparency is also true of the buffer in the Bufferati regime**. While the components of the current regime can be numerous, particularly for large firms, it is mostly clear why they have to hold these buffers. For example, O-SII, D-SIB and G-SIB buffers have to be held depending on a firm's size and the PRA buffer is based on scenario analysis and stress testing results. While we agree that the number of current buffers and how they interact is complex, combining them into one buffer that captures all of the same elements does not eradicate this complexity and reduces what transparency there currently is.

- Under the Bufferati regime, **the anchoring of overall requirements shifts** from a microprudential minimum requirement, based on an individual firm's business operations and RWAs, to an overall level of capital to be held in the system that falls within a macroeconomically optimal range. This shift introduces additional complexity and reduces the transparency in the system as individual requirements could be driven in large part by the riskiness of other market participants. The rationale for an individual firm's requirements becomes more difficult to explain in such a regime.

- **The concept of a macroeconomically optimal range could have material unintended consequences**. Assuming this range must be narrow in order to be meaningful, small and medium sized firms could be penalised if it was to be introduced. This is due to the fact that the overwhelming majority of risk to financial stability comes from a small number of the largest firms in the system. This is addressed in the current regime by some of the specific buffers these firms have to hold, e.g. G-SIB, D-SIB and O-SII buffers. However, the combination of a narrow optimal range in the Bufferati regime, and large firms contributing most to the overall level of risk in the system, could see this range being set above the total requirements currently in place for small and medium-sized firms, despite the riskiness of their operations being unchanged.

- Finally, **a comparison between the capital and liquidity regimes supports our view** that Bufferati would not address the core complexities in the capital regime. Adopting the Bufferati regime could align the key capital metric more with the key liquidity metric, the Liquidity Coverage Ratio (LCR), in that it would be a single number that firms must comply with, and it's all a buffer that can be drawn down in times of stress (ignoring the minimum capital requirement to be maintained). However, in line with the underlying RWA-related complexities, there are interpretation, methodology and capability challenges that firms face when it comes to calculating the different components required to generate an LCR figure. Also, the LCR remains a predominantly micoprudential focused metric – firms do not have to maintain a level which falls witin a macroeconomically optimal range.

Conclusion

While we understand the reasons for Sam's speech and agree that the current framework is complex, in our view the Bufferati does not necessarily present a *simpler* regime. An approach that's based on a mix of risk-weighted and leveraged-based requirements, involving a minimum requirement and a buffer component, and that is informed by stress testing / scenario analysis, resembles the current regime in many ways.

Challenges with transparency.The Bufferati regime, while having fewer components, lacks the transparency of the current regime in terms of understanding the specific reasons for the quantum of capital being held by any bank and hence the quality of its assets.

Complexity built over time continues to be. In addition, Bufferati does not address what we view to be the key source of complexity in the current regime, and the one that presents significant risk, and that is the risk-weight and leverage calculations that underpin the regime; these components would remain in the Bufferati regime.

The value in, and effectiveness of, any capital regime comes from a clear understanding of its components but also an accurate view of the underlying risks it is designed to mitigate. In the absence of these key characteristics, Firms potentially would not be better equipped to take actions in a stress scenario to support the real economy.

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