Designing Countercyclical Capital Buffers

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DESIGNING COUNTERCYCLICAL CAPITAL BUFFERS

BY BRETT H. McDONNELL*

I. INTRODUCTION

The financial crisis of 2008 has brought banking, financial markets, and financial regulation back to center stage. For decades, Americans could assume that recessions, even depressions, caused by financial panics were a thing of the past. No longer. Now we must re-examine how to regulate banks and related financial institutions and markets.

One design issue in this re-examination is how regulation responds to cycles in financial markets. Observers have long noted that ideally we would like financial regulation to be countercyclical. That is, regulation should grow stronger as financial markets head into periods of speculative booms, bubbles, and excessive debt, while regulation should be loosened during and after crises in order to give financial institutions room to extend more credit in support of a recovery. Alas, buffeted by the same factors which cause cycles in financial markets, financial regulation instead tends to be procyclical, loosening during booms and getting tougher after crises.

How might we combat this tendency, and make financial regulation countercyclical rather than procyclical? One option is to try to build countercyclicality explicitly into the rules, tying the strength of regulation to determinations of where financial markets currently stand within a cycle. Doing that is easier said than done, but several of the leading regulatory responses to the 2008 financial crisis have tried. In particular, both the Dodd-Frank Act1 and the new Basel III international agreement2 face up to the issue in designing capital requirements for

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banks and related financial institutions. Basel III and proposed U.S. regulations implementing Basel III and the Dodd-Frank requirement create a new "countercyclical capital buffer" which in times of perceived booms in credit markets imposes a higher level of capital reserves on regulated entities. When a crisis hits, this capital buffer is supposed to be eliminated.

This essay briefly explores why financial regulation tends to be procyclical, how the new capital buffer attempts to address that tendency, and how well the attempt is likely to work. The verdict is mixed. The new countercyclical buffer may do some good. However, some features in its design may lead to it not being triggered when it should, and to weakening its effect even when it is triggered. I suggest some design tweaks which may help.

The essay is organized as follows. Part II analyzes the psychological and political factors which create the core problem of procyclicality. Part III describes the new countercyclical capital buffer rules. Part IV examines how the new buffer is triggered, and suggests a better process. Part V explores a few other issues in the design of the new buffer. Part VI concludes.

II. COMBATING PROCYCLICAL REGULATION

Banks and other financial institutions and markets that resemble banks are subject to cycles. In boom times, they engage in speculative lending that builds up excessive levels of leverage. Eventually the bubble bursts, and the system heads into a crisis. Banks with too much debt begin to fail, and their failure leads to a contagious panic. In response even relatively healthy entities cut back on their lending. The crisis in the financial sector leads to recession in the real economy, which in turn worsens the financial crisis. As the world is currently

4. See infra Part II.
5. See infra Part III.
6. See infra Part IV.
7. See infra Part V.
8. See infra Part VI.
experiencing, it takes a long time to recover from such a crisis.9

We would like financial regulation to lean against this wind and try to limit the severity of such cycles. That is, regulation should become tougher as booms start to turn speculative in order to limit the degree of unwise speculation and lending that occurs, and become more forgiving in the wake of a crisis so as to not block needed investment during hard times.10 Alas, that is not what we observe. Typically, regulation actually tends to loosen during the booms, then strengthen with reforms following a crisis. Regulation in practice is procyclical, whereas in theory it should be countercyclical.11 The same psychological biases (particularly the availability bias) which affect actors in the financial markets also affect regulators, both directly and via political pressure on them.12

Many have noted this tendency to procyclical regulation. However, they have differed markedly in their positive and normative analyses of the nature of the problem at different stages of the cycle. I have analyzed these differences elsewhere, and grouped analysts within three competing types of models.13 Those in model 2 are skeptical of much financial regulation, and see the main threat in the tendency to over-regulation following crises.14 Those in model 3 think financial regulation tends to be too weak, and see the main threat in the tendency to de-regulation during boom periods.15 Those in model 1 see both


13. Id.


15. Id. at 14-16. See also, e.g., JOHN C. COFFEE, JR., THE POLITICAL ECONOMY OF DODD-FRANK: WHY FINANCIAL REFORM TENDS TO BE FRUSTRATED AND SYSTEMIC RISK PERPETUATED
over-regulation following crises and under-regulation during booms, although some semi-optimistically note that at least these countervailing effects tend to lead to a relatively proper level of regulation in the long run.16 The group a person identifies with naturally affects their prescriptions for regulation. In what follows, I shall put myself in model 1, and hence be concerned with mistakes in both phases of the cycle, for reasons I have developed elsewhere.17 However, I shall also consider how advocates of models 2 and 3 might react differently to the issues discussed below.

One obvious way to react to this problem is to try to build countercyclical rules directly into legislation and regulation.18 Possibly the leading attempts to do so in financial regulation are the Dodd-Frank and Basel III countercyclical capital buffers which are at issue in this paper. How should such countercyclical rules work, and what are the chances for success given the cognitive and political pressures for procyclical regulation? We would like the rules to be as automatic as possible, subject to as little discretion from regulators as possible, given the cognitive and political pressures on the regulators. Insofar as we deem it necessary for regulators to retain some degree of discretion, we want those regulators to be insulated from political pressure (which tends to be procyclical), and we want to do what we can to limit the influence of the various cognitive biases on them.

Why might we want to retain any discretion, given the hazards? The difficulty is coming up with automatic rules that are triggered to strengthen and weaken at the right time. Automatic rules will need to use a measure or measures of economic conditions which specify when to tighten or loosen the rule. No measure will do a perfect job for this task, and with no discretion at all, they run the risk of sometimes setting the rule very badly indeed. Thus, there are some hard design choices to be made in balancing rules and discretion.19

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16. McDonnell, supra note 10, at 9-12. Another significant statement of this position is GERDING, supra note 11.
18. Id. at 32.
In thinking through these design choices, we should consider different types of errors that can be made, and their relative likelihood and severity given general features of the market and regulatory cycles. We want to consider how proposed countercyclical rules will function both in boom periods and following crises. In each period, two kinds of errors are possible. Drawing upon the terminology of statistics, we can label a type I error when the rule fails to change strength (increase in a boom, decrease in a crisis) when it should. In a type II error, the rule changes strength when it shouldn’t. We thus have four cases to worry about:

- Failing to strengthen during a boom (boom type I). Here, the countercyclical rule is failing in its basic purpose. It is not actively causing harm (relative to not attempting a countercyclical design at all), but it is doing no good. Where the rule design allows a good deal of discretion, the likelihood of this error is quite high, due to the cognitive and political biases which create procyclicality, although one can attempt to put in place features that shield regulators from these biases. For a highly automatic rule, the likelihood of this type of error depends upon the accuracy of the rule (this point applies for all types of errors with highly automatic rules; take it as given below). Research from economists at the Bank of International Settlements (BIS) suggests a measure which is fairly accurate at identifying speculative booms.

- Strengthening during a perceived, but not actual, speculative boom (boom type II). Here the countercyclical rule slows down lending and economic growth unnecessarily. Although it would have to get things quite wrong indeed to lead to a recession, it could lead to slower growth than would occur otherwise. Thus, for

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moderate versions of this error, the damage is not all that great. This error is quite unlikely for discretionary rules (since regulators are inclined in the opposite direction), and as just noted for automatic rules, it appears a measure (BIS Measure) is available which would make the error unlikely.

- Failing to weaken during a crisis (crisis type I). This type of error has the potential to cause great harm, as it may stop the economy from recovering after a crisis. However, there are reasons to be not heavily concerned about this type of error. For discretionary rules, once a crisis has become severe, regulators will recognize it—a financial crisis in full fury is hard to miss (there is an asymmetry here from speculative booms). And in the middle of a crisis, there will be pressure from bankers to weaken the rules. If a rule is supposed to be weakened in a crisis, it will be hard for regulators to avoid doing so. It is true that often during crises, regulators will strengthen existing rules and create new ones to address perceived problems that led to the crisis. They may increase the baseline strength of the rule in question (capital requirements in our case—as indeed has happened with Basel III). However, they would seem to be unlikely to maintain the countercyclical component of the rule at high strength, given the obviousness of crisis conditions. What is more likely, though, is that under discretionary rules, regulators may miss the early signs of a crisis, and thus not weaken the rule as early as one would hope. For automatic rules the BIS researchers have not found quite so accurate a measure for crises, so
there is some real risk for this type of error. But here too, once the crisis truly hits in full force, plausible measures should identify that. Thus, for both discretionary and automatic rules in times of crisis, the rules may be somewhat slow to identify the crisis in its early stages, but they are quite likely to identify the crisis once it becomes severe. This fact greatly reduces our concern for crisis type I error, because of the nature of lending during and after crises. As a crisis builds, lending is likely to fall (eventually, to plummet), pretty much no matter what the regulatory climate is. During the early phase, regulatory loosening following a countercyclical rule is thus unlikely to help. Where the loosening matters more is in the time following the trough of the crisis, when recovery begins. Here, overly tight rules can do serious harm, but as we have just seen, the likelihood of this type of error lasting to this point is quite small.

- Weakening during a perceived, but not actual, crisis (crisis type II). When this sort of error happens, the countercyclical rule which has been strengthened to combat a speculative boom is weakened prematurely, while the boom continues. As with a boom type I error, the countercyclical structure thus fails to do what it is supposed to, allowing speculation to increase and making the future crisis worse than it would be in the absence of this error. With discretionary rules, there is a decent likelihood of this occurring, given the cognitive and political biases during booms. Due to the more questionable quality of available economic measures identifying the onset of crisis, this error may also be decently likely with automatic

21. Id.
rules.

Given the imperfection of both regulators and economic measures of booms and busts, no countercyclical rule policy can reduce the possibility of all four types of errors to zero. Different rules will produce a different mix of probabilities for the four types. We are thus looking for a mix of rule and discretion which achieves the best tradeoff available among them. In Part III we will look at the rules that have been proposed by U.S. and international regulators, and then in Parts IV and V we will evaluate those rules within the framework discussed here.

III. BASEL III AND PROPOSED IMPLEMENTING REGULATIONS

In this section I will first very briefly outline the basic structure of capital requirements under U.S. banking regulation and Basel, and then describe the proposed countercyclical capital buffers.

In the 1980s, U.S. banking regulators introduced risk-weighted capital requirements. To avoid imposing a competitive disadvantage on U.S. banks, U.S. regulators worked with the leading banking regulators of other countries to produce the Basel I rules,\(^{22}\) which impose risk-weighted capital requirements on banks in most of the world. Capital requirements are a way of reducing leverage and of trying to assure that banks have resources available to cope with hard times. The risk-weighted requirements of Basel I look to a fraction. In the numerator of that fraction is a measure of the capital of a bank. Capital comes in various forms, more or less sure and readily available to the bank in bad times. Basel I divides capital into Tier I (the safest kind) and Tier II, and includes several relevant measures based on each. In the denominator is a measure of a bank's assets. These assets are weighted by their perceived riskiness, with each type of asset being assigned to one of a few categories and weighted by the risk level assigned to that category. Once the measures of capital and assets are calculated, the divisions are done to produce the capital measures.

In the U.S., these measures are then used within the supervision and prompt corrective action system. There are various levels of capitalization based on the measures (well-capitalized, adequately

capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized), and the activities of a bank are more restricted the more undercapitalized it is.\textsuperscript{23} Basel II modified the way asset risk was calculated, in ways not relevant to our discussion here.\textsuperscript{24}

Basel III made further modifications to the calculation of both assets and capital, again not relevant to our discussion here.\textsuperscript{25} It increased the required capital requirements. For the measure using all allowable forms of capital, a bank must have capital equal to at least 8\% of risk-weighted assets in order to be well capitalized. In addition, Basel III adds a capital conservation buffer and a countercyclical buffer. The capital conservation buffer of 2.5\% sits on top of the basic capital requirement. Thus, for the total capital measure, the combined level is 10.5\%. A bank between 8\% and 10.5\% will not face any of the restrictions of the prompt corrective action rules, but it will face a few restrictions. In particular, several forms of distributions from earnings will be limited or prohibited. Affected distributions include dividends, share buybacks, discretionary payments of some forms of capital, and discretionary bonus payments to staff.

The countercyclical buffer—our main concern here—augments this capital conservation buffer. When the relevant regulatory agency, or agencies, declares that this countercyclical buffer has been triggered, the capital conservation buffer will increase. The most the buffer will increase is an additional 2.5\%. Thus, when the countercyclical buffer is at its maximum, the cutoff level of total capital below which the distribution limits will apply is 13\%.\textsuperscript{26} In the U.S., the relevant regulatory agencies are proposing to apply the countercyclical buffer only to “advanced approaches banking organizations.” These are the large and sophisticated banks which are allowed to use their internal risk measures in calculating risk-weighted assets.\textsuperscript{27}

Who will determine what the countercyclical buffer is, and on what basis will they make that determination? Basel III leaves it to each

\textsuperscript{23} See 12 U.S.C. §§ 1818(b)(6), 1831o.
\textsuperscript{25} Basel III, supra note 2.
\textsuperscript{26} Basel III, supra note 2, at 54-58.
\textsuperscript{27} Implementation of Basel III, supra note 3, at 33.
country to choose an authority to make decisions on the buffer.\textsuperscript{28} In the U.S., under the proposed regulations implementing Basel III, the decision will be made jointly by the Office of the Comptroller of the Currency (OCC), the Federal Reserve (Fed), and the Federal Deposit Insurance Corporation (FDIC).\textsuperscript{29} An increase in the buffer will take effect twelve months after it is announced, in order to give banks time to build up their capital, while a decrease will take effect immediately.

The international guidelines for setting the buffer begin with one statistical measure as a reference guide, the aggregate private sector credit-to-GDP gap.\textsuperscript{30} The Basel committee gives fairly precise guidance on calculating this number. One takes a broad measure of the total credit in the private sector (with the statistical measure to use specified in some detail), divides this by GDP, calculates the long term time trend of this figure using a specified statistical procedure, then calculates the percentage deviation from trend of the current figure. The guidance then specifies levels of this number at which one should expect the buffer to increase.\textsuperscript{31} However, this figure is just a starting point. The national authority is expected to start with the number, but then exercise judgment, guided by several broad principles.\textsuperscript{32} This thus represents a blend of rule and discretion, discussed in more detail in the next part.

The U.S. regulatory agencies do not quite propose to follow this guidance. They state that they expect to consider a range of macroeconomic, financial, and supervisory information indicating an increase in systemic risk. This information includes, but is not limited to, the ratio of credit to gross domestic product, a variety of asset prices, other factors indicative of relative credit and liquidity expansion or contraction, funding spreads, credit condition surveys, indices based on credit default swap spreads, options implied volatility, and measures of systemic risk.\textsuperscript{33}

Thus, the U.S. agencies do not focus on one statistic to the

\begin{footnotesize}
29. Implementation of Basel III, supra note 3, at 34.
32. Id. at 2-5.
33. Implementation of Basel III, supra note 3, at 34.
\end{footnotesize}
extent suggested in the Basel guidelines. Although the Basel statistic is the first specific statistic listed by the U.S. agencies, it is the first in a rather long list. As will be discussed in the next part, such a laundry list in effect grants the agencies a very wide degree of discretion.

IV. ISSUES WITH THE TRIGGER

Our discussion in Part II suggested that we should look for a rather rule-like, automatic trigger for setting the buffer level, one which leaves regulators little discretion, because of the various biases which are likely to afflict regulators. Given the imperfection of usable statistical measures, we want to maintain some discretion, but it should be limited.  

The Basel mechanism does not fully fit that description, and the proposed U.S. implementation is yet more wide of the mark. Basel does start with one reference statistic, the credit-to-GDP gap, as one would want in a rule-based approach. However, it then stresses that regulators must use broad judgment rather than rely on this measure, although it does lay out a few principles to guide that judgment. The resulting degree of judgment and discretion seems rather more than is desirable, at least insofar as one believes that the core statistic is quite reliable. The U.S. proposed implementation strays further from a rule-like procedure because it does not single out one statistic as a starting point. Rather, it sets out a range of statistics to which regulators will look, without saying anything about relative priority or about the range of values for specific statistics which may indicate a desirable change in the buffer level. Such a smorgasbord of available data essentially gives

34. There is a separate reason why the Basel rule should probably not be more rule-like than it is. Basel sets an international standard, which must then be implemented by national regulators. There are good reasons why one might want the international standard to give national regulators plenty of room to design their own rules, even if one thinks that those national regulations should themselves be quite rule-like. Thus, it is possible that in this case, even though Basel is more rule-like than the American regulation, still the Basel regulation is more rule-like than it should be as an international standard, while the American regulation is less rule-like than it should be as an implementation of that international standard. For a discussion suggesting that in general Basel should move towards a less rule-like approach, see Claire A. Hill and Brett H. McDonnell, International Financial Regulation: First, Do No Harm, in FESTSCHRIFT KIRCHNER (Wulf Kaal et al. eds. forthcoming 2014).

35. See BASEL COMM. ON BANKING SUPERVISION, supra note 24.

36. See Guidance, supra note 30, at Annex 1; Drehmann et al., supra note 20.
regulators largely unfettered discretion, which we have seen is undesirable.

What might a more rule-bound countercyclical rule look like? Basel III gets fairly close. Imagine the following modification. Start with the statistic featured in Basel III, and specify various levels of that statistic which should trigger increases in the buffer, as Basel III does. Now, instead of then leaving it all to regulatory judgment, state that it is an explicit presumption that the buffer level should change when the indicated statistic levels are reached. However, the presumption should be rebuttable by the relevant regulators. It should not be easily rebuttable, though. The rule should state that if regulators choose to deviate from the presumed level, they must justify their decision publicly. The rule should give guidance as to what such justification should entail, with the Basel III guidance already giving a pretty good outline for such guidance. Depending upon the decision making structure of the relevant regulator, one also might want to impose procedural limits on decisions to deviate, for instance a supermajority voting rule.

In the U.S., three regulators will jointly set the countercyclical buffer. Two of these (the Fed and the FDIC) are independent agencies, as one wants in order to limit political pressure and resulting procyclical bias. The other, the OCC, is an agency of the Treasury, and hence more politically accountable.37 It is not at all clear if one should really want the Treasury involved. However, assuming its involvement is inevitable (which politically seems likely), we can make good use of the involvement of three regulators to impose a procedural rule limiting discretion to vary from the presumptive level: require agreement from all three agencies to justify a variation from the presumptive level.

37. The OCC is in some ways more independent than many agencies. For instance, its budget is largely set through an assessment on banks rather than being dependent upon Congressional appropriations, see 12 U.S.C. § 16, and the Secretary of the Treasury may not delay or prevent the issuance of rules which the OCC promulgates, see 12 U.S.C. § 1(b)(1). However, the President may remove the Comptroller for cause. See 12 U.S.C. § 2. Moreover, the OCC is headed by one person (the Comptroller) rather than by a multi-person Commission which must include representatives of both parties. A limit on removal without cause and the use of a multi-person bipartisan commission are both conventionally seen as critical elements of agency independence, see Kirti Datla and Richard L. Revesz, Deconstructing Independent Agencies (and Executive Agencies), 98 CORNELL L. REV. 769, 776 n. 24 (describing while contesting the “consensus view” that a for-cause removal clause constitutes the central dividing line defining independent agencies), and the Federal Reserve and FDIC both possess these features of independence.
How would such an approach fare with our four types of errors? For boom type I error, the credit gap statistic works well historically, and makes good intuitive and theoretical sense. So starting with that statistic ought to lead to increases in the buffer in most instances when an increase is appropriate. Given both regulatory biases and the limits on regulator discretion of the proposal, regulators are unlikely to adjust upward where the statistic fails to properly indicate a change. Therefore, boom type I errors would still occur, but they should be infrequent so long as the statistic works well. The limits on regulator discretion should make it hard for regulators to block an increase when the statistic rightly calls for one; however, it could still occur. The main point of the limits on discretion is to prevent regulators from blocking an increase when the statistic calls for it, the main threat for creating this type of error. As long as there is any discretion, this type of error can still occur—determined regulators may choose to override the presumed increase. But unless one really trusts the available statistics quite a bit, or sees the harm from this type of error as quite limited, one presumably wants to leave some degree of discretion, albeit tightly constrained. In contrast, the high degree of regulator discretion under the approach suggested by the U.S. agencies would create a high likelihood of this type of error, threatening to undermine much of the point of the countercyclical buffer.

For boom type II error (inappropriate strengthening), again the relative accuracy of the statistic gives a good starting point. Moreover, for this type of error the backdrop of some regulator discretion gives some chance of correcting such an error (this, after all, is the main point of retaining some discretion). If the main statistic incorrectly indicates a buffer increase where it is inappropriate, regulators are likely to want to block the increase, and in such instances they should be able to point to many other measures set out in the rule which suggest an increase is inappropriate (it would be unlikely for all of the statistics to uniformly point to an increased buffer where such an increase is truly inappropriate and harmful). It must be admitted, though, that this type of error is more likely under my proposed approach than under that proposed by the U.S. agencies, where it is very unlikely indeed.

For crisis type I error (failure to weaken), there is some real concern that the leading statistic will be slow to identify an emerging crisis, and even that the regulators will be slow to act to override the
statistic's presumption. Among other things, the BIS's own economists are more skeptical about the functioning of the credit-to-GDP gap in identifying a crisis.\textsuperscript{38} Indeed, their work suggests alternative statistical measures to use in this phase of the cycle, which suggests a different triggering measure for our presumptive rule when it comes to reducing the buffer. Still, as noted above, when a financial crisis really hits, it is unmistakable, and even if the main statistic one uses does not respond, regulators will know that a crisis has hit and it is time to lower the buffer.\textsuperscript{39} And as noted above, some tardiness in lowering the buffer during a crisis is unlikely to cause too much extra damage as long as the buffer is lowered by the time the worst of the crisis has passed, since in the middle of the crisis banks will be very conservative anyway.

For crisis type II error (weakening when unjustified), the tendency of the leading statistics to reflect an emerging crisis rather slowly makes this type of error fairly likely for our rule-bound suggested approach. The ability of regulators to overcome the presumption may increase the likelihood of this error somewhat, but given the limits on their discretion, one hopes this effect will not be too significant. Even if this error does occur, its effects may not be that dire. I do not have a terribly clear sense of how crisis type I and II errors would act in the U.S. proposed highly discretionary approach as compared with my more rule-based system. Perhaps, type I error would be a bit less likely and type II a bit more under the regulators' proposal, but I doubt the differences would be all that great.

No system is perfect. Any suggestion would create some risk of all four types of errors, with significant likelihood for at least some of them. Still, the above argument suggests a more rule-based alternative along the lines suggested here, rather than leaving regulators with as much discretion as the U.S. proposal. The key difference, swamping the others, is boom type I error, i.e. failing to increase the countercyclical buffer when conditions warrant an increase. This type of error is quite likely to occur under the proposal of U.S. regulators, calling the whole point of the countercyclical buffer into question. The more rule-based approach would significantly reduce the probability of this type of error, with only limited cost in the increased probability of other types of error.

\textsuperscript{38} Drehmann et al., \textit{supra} note 20.

\textsuperscript{39} See \textit{BASEL COMM. ON BANKING SUPERVISION}, \textit{supra} note 24.
V. Other Design Issues

Several other elements in the design of the Basel III countercyclical buffer and its proposed U.S. implementation deserve some comment and questioning.

As noted above, the U.S. regulators propose limiting the countercyclical capital buffer only to "advanced approaches banking organizations," the largest and most sophisticated of banks. They justify this by saying that the failure of such banks poses a greater risk to the financial system, and therefore there is more need of a capital buffer to prevent them from failing.\(^4^0\) However, many smaller banks following similar strategies all failing at the same time can pose as much risk as one bigger bank with as many total assets. After all, the grandfather of all bank crises, the Great Depression, flowed from the mass failure of many small banks, not a few "too big to fail banks." In general, I think the "too big to fail problem" is somewhat exaggerated relative to other issues in financial regulation.\(^4^1\) That is not to say that too big to fail is not a problem at all, and I do believe that a higher capital requirement for systemically important institutions is quite a good idea. But I do not see any particular connection to the countercyclical buffer problem.

Another matter of some concern is the twelve month delay in effectiveness for increases to the countercyclical capital buffer. This exacerbates the cost of boom type I errors, the core error threatening the effectiveness of this whole endeavor. There is a strong built-in tendency for the regulatory system to be slow in recognizing the creation of a speculative boom. More automatic rules will reduce this tendency, but even statistics are often somewhat slow in revealing major changes in market dynamics. Waiting an entire year for buffer increases that will often already be rather late in being announced may seriously diminish the effectiveness of the whole countercyclical buffer requirement.

The justification for the twelve month delay is to give banks time to build up their capital to the newly required level.\(^4^2\) Given the
fairly light consequences that flow from a bank’s capital level falling within the buffer zone—doing so only limits the bank’s ability to make certain distributions from earnings—I am not sure I see the need for this delay. Even if one believes some delay is necessary, need it be a whole twelve months? One way of giving effect to the change more quickly would be to increase the buffer in stages. For instance, after an increase is announced, one could implement 25% of the increase in three months, 50% in six months, 75% in nine months, and the full increase in twelve months.

The final, and perhaps biggest, design issue I’d like to discuss is the link of the countercyclical capital buffer to the capital conservation buffer. As noted above, the consequences of falling within the buffer zone are not severe, with affected banks only having to limit some distributions from earnings.43 Does this really do enough to limit speculative activities during a boom? I am skeptical. The countercyclical measure would have more bite if it increased the levels of capital required to qualify as well-capitalized, adequately capitalized, and so on. As noted above, falling below these levels has a wider range of consequences, imposing ever greater restrictions on banks the lower the capitalization level in which they are categorized. I will note a counter-consideration to this point, however. I suspect that regulators have designed the countercyclical buffer in this way precisely because they are concerned about pushback if they give the new requirement too much bite. If so, and if the change I suggest were made, regulators might be more worried about increasing the countercyclical capital requirement. Even with limits to their discretion, they might be worried enough to brush aside those constraints and prevent an increase. If so, perhaps it is worth having a countercyclical rule with weaker consequences if that very weakness makes regulators more willing to make countercyclical adjustments.

VI. CONCLUSION

We have seen why procyclicality is counterproductive and yet is still a common feature of financial regulation. We have also seen how Basel III and the proposed regulations implementing Basel III in the U.S. attempt to insert a degree of countercyclicality into capital

43. See Basel Comm. on Banking Supervision, supra note 24.
requirements. The result is still a work in progress. The new rules are better than nothing, and may do some good. However, they could be better. The U.S. regulations in particular should rely less on the discretion of the financial regulatory agencies in deciding when to trigger the capital buffer. The whole reason that we need the countercyclical buffer is that a variety of cognitive and political factors tend to make regulators let down their guard when financial markets get frothy. A rule trying to combat those factors should not rely upon the largely unconstrained discretion of those regulators. More rule, less discretion please.