The voice of banking
& financial services

11th October 2013

baselcommittee@bis.org
Wayne Byres
Secretary General
Basel Committee on Banking Supervision
Bank of International Settlements
CH-4002 Basel
Switzerland

Dear My Byres,

The regulatory framework: balancing risk sensitivity, simplicity and comparability

The British Bankers' Association (BBA) is pleased to respond to the Basel Committee on Banking Supervision's discussion paper.

The BBA is the leading association for UK banking and financial services representing members on the full range of UK and international banking issues. It represents over 200 banking members active in the UK, which are headquartered in 50 countries and have operations in 180 countries worldwide. All the major banking groups in the UK are members of our association as are large international EU banks, US and Canadian banks operating in the UK as well as a range of other banks from Asia, including China, the Middle East, Africa and South America. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum from deposit taking and other more conventional forms of retail and commercial banking to products and services as diverse as trade and project finance, primary and secondary securities trading, insurance, investment banking and wealth management. Members include banks headquartered in the UK, as well as UK subsidiaries and branches of foreign banks – all of which are potentially impacted by this Consultation Paper.

Key messages relating to each of the five questions are as follows:

1. **The current framework**:
    a. We urge the Committee to continue to retain and enhance the role that risk-sensitivity plays in the framework.
    b. We believe that the current framework by promoting the modelling and estimation of losses does promote improved risk measurement and management within banks.

2. **Other objectives**:
    a. We consider that the Committee and regulators should take into account an additional objective to ensure that the capital adequacy framework including the leverage ratio is appropriate to the economy in which a bank operates.

3. **Striking the right balance:**
    a. We believe that the focus should be on continued improvements in risk measurement to improve comparability rather than any tilt towards simplicity.
    b. We agree with the Committee's view that improvements in the comparability of capital ratios are vital to improve investor and public confidence.

c. The continued use of risk-sensitive internal and appropriately calibrated BCBS models to estimate losses, to determine capital requirements and other measurements of risk should be pursued.

4. **Comments upon other potential ideas put forward by the Committee:**
    a. We do not support the proposal that simplicity should be an additional objective in itself. However we would support the notion that the regulatory framework should not be unduly complex.
    b. We support continued enhanced disclosure where it adds to the transparency of explaining the capital ratios and all other measures that in turn drives investor confidence.
    c. We would encourage the Committee to proceed carefully by conducting its own research before mandating any further metrics to be published.
    d. We support benchmarking as a tool to compare the outcome of modelling the same drivers of risk.
    e. We believe that the Committee, regulators and banks should work more closely together to comprehend the differences between “regulatory capital” and “internal capital” in order to narrow the gap between the two approaches. This would in turn improve risk management and reinforce the importance of the use test
    f. We recognise that floors and overrides - when judicially and transparently - applied to banks within their jurisdiction may have a role to play and thus can improve comparability within the particular jurisdiction. However, we encourage the Committee to reaffirm its commitment to the use of Pillar 2 to address any concern with respect to the adequacy of capital in individual banks.
    g. Banks believe that having a regulatory capital framework based upon risk is fundamentally correct, and improvements should be made gradually, refining and building-upon the current framework as the industry evolves
    h. We view the Basel Committee's websites as very user friendly and commend the Basel Committee for the approach it has taken.

5. **Other ideas and approaches that the Committee should consider:**
    a. We believe that the current approach and the initiatives that are being taken together with adoption of the suggestions put forward in this response would go towards achieving the objectives set out in paragraph 29. Specifically we welcome the fact that regulators are now looking at the structure of banking groups in order to determine how for example “principal UK-regulated solo entities within these financial groups will be treated as part of the stress testing exercise”. Banks also support the efforts by regulators to establish robust resolution regimes for all significant banks that will when fully implemented contribute to the Committee’s objectives.
    b. One area the Committee may wish to examine is the difference between the Standardised and IRB approaches for exposures to Sovereigns and Banks and to provide opinions on whether or not effort should be spent by banks to model uncertain events that are difficult to ex-ante predict and ex-post to validate

Significant time and effort has been expended by the Committee, regulators, politicians and the banking sector on the implementation of Basel 3. Whilst there are always refinements and improvements to be made, we encourage the Committee to continue forward on that path, to continue to support a risk-based approach to setting regulatory capital with no significant change in principle.

The following 5 pages set our response in further detail.

1. Does the current framework, with its reliance on the risk-based capital at its core, appropriately balance the objectives set out in paragraph 29?

We agree that the risk-based based capital aspects of the various standards and models that have been developed by the Committee under which a bank is required to use to estimate total (and or unexpected) losses derived from credit, operational and market risks are well defined and well understood within the banking community. These models are essential for the risk management and risk measurement of the business, and any move away from this would be a backwards step.

It is recognised that different approaches have different degrees of risk-sensitivity, which is a characteristic that is essential for capital assessment, and that is why we urge the Committee to continue to retain and enhance the role that risk-sensitivity plays in the framework. Having said this, it is acknowledged that there is an external perception that the models are complex “black-boxes” that make comparisons (across both banks and time) difficult. As a result we feel it is incumbent on BCBS members to help create a more balanced context to these issues.

The standards do deliver *a well-understood measure of capital adequacy for internationally active banks that can also be used for smaller institutions.* However, given the fact that banks have different measurement processes (some of which are influenced by local regulators), use different measurement approaches from the options provided by the Committee (under Basel II and Basel III) and publish different capital ratios, it does make comparability across banks more difficult. During the transition period to implement Basel III it will also be difficult to compare individual banks across time. Notwithstanding these matters, to the extent that the Committee believes that the amount of Core Tier 1 Equity held by each bank will be appropriate then one can conclude that the current framework does *support a reasonable level playing field between banks.*

Banks that develop internal models to estimate expected losses for use in pricing risk, and parameters for use in economic capital and portfolio management are able *to take into account the effects of capital requirements on banks' risk-taking incentives, e.g. when faced with regulatory constraints on their capital (and therefore the size of their balance sheet).*These internal processes are established to ensure that shareholder funds are appropriately allocated to optimise the returns to ordinary shareholders commensurate with the bank’s appetite for risk that is aligned with its strategy. We would not wish to have these undermined by risk insensitive requirements that undermine banks’ ability to price according to economic fundamentals.

In conclusion we believe that the current framework - by promoting the modelling and estimation of losses - does promote improved risk measurement and management within banks. Significant time and effort has been expended by the Committee, regulators, politicians and the banking sector on the implementation of Basel 3. Whilst there are always refinements and improvements to be made, we encourage the Committee to continue forward on that path, to continue to support a risk-based approach to setting regulatory capital with no significant change in principle.

2. Are there other objectives that should be considered in reviewing the international capital adequacy framework?

Banks recognise that it is a challenge to align supervisory oversight of banks with the effect of fiscal and monetary policies to ensure the on-going financial stability of each economy and thus ensure the safety and soundness of the banking sector. That is why we consider that the Committee and regulators should take into account an additional objective to ensure that the capital adequacy framework, including a leverage ratio used as a backstop measure, is appropriate to the economy in which a bank operates.

By doing so this might have the bi-product of aligning macro-prudential modelling of the local economy with the modelling of bank capita. This in turn could facilitate continued improvements to stress testing banks on an individual basis and the sector on an aggregate basis.

Banks do though believe that more could be done to align the regulatory capital framework with the financial accounting (IFRS) framework in order to better align these two views of the soundness of a bank as a going concern.

3. **To what extent does the current capital framework strike the right balance between simplicity, comparability and risk sensitivity, given the costs and benefits that greater risk sensitivity brings?**

We believe that the focus should be on continued improvements in risk measurement to improve comparability rather than any tilt towards purely presentational simplicity. Members agree with the Committee's view that some improvements in the comparability of capital ratios can help improve investor and public confidence. We would encourage the BCBS to gauge opinion from the Investor community to inform how comparability could be improved. However members would encourage the BCBS to consider providing further clarity on existing (Pillar 3) reporting, rather than adding to the quantum of ratios and metrics being reported. The objective should be to improve comparability whilst not adversely impacting upon risk management and considering any increased burden of reporting on banks.

It is important to stress that in order to continue to achieve the objectives set out in paragraph 29, equal attention is given to other aspects including an effective risk appetite and enterprise-wide governance framework, appropriate buffer of retained earnings (and or access to equity investments) to withstand volatility in losses that cannot be covered through operating profit, a suitable leverage ratio consistent with the risk profile as well as prudent liquidity ratios. In the latter regard the implementation of the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) are important tools to improve the measurement and management of risk.

In conclusion, the continued use of risk-sensitive internal and appropriately calibrated BCBS models to estimate losses, to determine capital requirements and other measurements of risk should be pursued.

4. Which of the potential ideas outlined in Section 5 offer the greatest potential benefit in terms of improving the balance between the simplicity, comparability and risk sensitivity of the capital adequacy framework?

Explicitly recognising simplicity as an additional objective

Members do not support the proposal that simplicity should be an additional objective in itself. However we would support the notion that the regulatory framework should not be unduly complex. Simplicity in itself does not necessarily improve comparability, but it can mask risk-sensitivity, the true measures of risk - specifically the volatility of outcomes. We believe that when given the choice between simplicity and risk-sensitivity, we encourage the Committee to remain focussed on the later and not view simplicity as a panacea for failings in risk measurement. The appropriate use of statistics is necessary in this regard.

We also note that, if risk is defined as a volatility measure, then recognition should be given to banks managing uncertainty as well, particularly where insufficient data is available for modelling. We suggest that the Basel Committee openly acknowledges that expert judgement has a role to play in bank's ability to manage uncertainties.

Enhancing disclosure

Banks support continued enhanced disclosure where it adds to the transparency of explaining the capital ratios and all other measures that in turn drives investor confidence. Therefore banks support continued improvements to Pillar 3 disclosures and welcome the work that continues to be conducted under the auspices of the Enhanced Disclosure Task Force. However, it is important that equal focus is placed on aligning the format of disclosures, moving towards consistent definitions of terms to enhance comparability. We encourage the Committee to gauge investor's opinion on what they would like to see in Pillar 3 disclosures.

Using additional metrics

Banks would encourage the Committee to proceed carefully by conducting its own research before mandating any further metrics to be published. Members already produce a wealth of information that can be accessed by investors and supervisors, and careful consideration should be given before increasing the quantum of these metrics. This will help ensure that the benefits are appropriate to the costs. We encourage the Committee to talk to investors to seek out their opinions on these matters

Ensuring the effectiveness of the leverage ratio

Members' views with respect to the introduction of the leverage ratio have been already communicated to the Committee. For example the ib*fed* on 20th September 2013 commented that it a) supports the supplementary leverage ratio as a backstop, b) fears that the backstop leverage ratio, as currently conceived, is in fact a binding constraint, c) netting should be respected, d) a consistent application is key, and there is need to look at the matter relating to the accounting treatment of operating leases.

Utilising added floors and benchmarks to mitigate the consequences of complexity

There are two separate matters.

Members would discourage the Committee and Supervisors from using floors in order to compensate for actual or perceived, model risk. Instead consideration should be given to quantifying model risk, and recognising this in the regulatory models. Floors in the determination of modelling total losses do have a role to play, but in the opinion of banks should be used sparingly as they can distort risk sensitivity, and could encourage undesirable behaviours if higher risk is not associated with higher regulatory capital requirement. In addition, the use of supervisory overrides in internal models can create issues with respect to compliance with the use test. We encourage the Committee to address concerns with regard to model risk by either reviewing the calibration of the Committee's models and or by quantifying the model risk.

We support benchmarking as a tool to compare the outcome of modelling the same drivers of risk. However, the drivers of the calculation of total losses utilising the Standardised Approach and IRB Approaches and outcomes are different. The treatment of adjustments to Core Tier 1 Equity and Total Capital is also different. This creates difficulties for using one approach as a benchmark for the other. Banks are concerned that publically disclosing bench-marking of a capital ratio based upon IRB with a capital ratio based upon Standardised Approach will lead to a perception that one approach is preferable to the other. There are valid reasons why banks should use each of these approaches. We believe that the Committee should focus its efforts on reducing the difference between two approaches rather than favouring one over the other for benchmarking.

Reconsidering the linkage between internal and regulatory models

In developing its own risk models, whether for economic capital, decision or portfolio management, banks seek to comprehend the true risk including tail risk. This is also different from the notion of "uncertainty", for which other mitigates is more relevant.

An important purpose of a bank's modelling is to facilitate a comparison with the calculation of losses derived from the BCBS models, referred to by the BCBS as "regulatory capital". Banks are pleased that the BCBS recognises that there are differences in the outputs from the BCBS credit risk regulatory capital models and banks internal models. Both economic and regulatory capital models use the same building blocks of PD, LGD, EAD and residual maturity. As the Committee will be aware, when banks use a one-year time horizon and 99.90% level of confidence, it is differences between the other model parameters explicit in the BCBS credit risk model, as well as other factors that are explicitly missing from it (such as concentration risk) that are the primary reasons for the differences in outputs.

Banks believe that the Committee, regulators and banks should work more closely together to comprehend the differences between "regulatory capital" and "internal capital" in order to narrow the gap between the two approaches. This would in turn improve risk management and reinforce the importance of the use test.

Limiting national discretion and improving supervisory consistency

Banks recognise that when a regulator looks at the output from a model of bespoke portfolios across a number of banks, it might be that they do not consider that the marginal contribution to the total loss of the entire portfolio of risk is sufficiently conservative for the risk it poses within their jurisdiction. Thus banks recognise that floors and overrides - when judicially and transparently - applied to banks within their jurisdiction may have a role to play and thus can improve comparability within the particular jurisdiction. However, banks encourage the Committee to reaffirm its commitment to the use of Pillar 2 to address any concern with respect to the adequacy of capital in bank. If though a regulator believes that the use of its national discretion mitigates systemic risk, and it is consistently and rationally applied, then banks support the use.

Nonetheless in order not to undermine the use of these models in a bank's own risk assessment, banks would encourage the Committee to accomplish their objectives by refinements to the transformation of the banks inputs into outputs, rather than mandate changes to the inputs. Banks note as an example that this approach was adopted in Basel 3 with the 1.25 multiplier applied to the correlation parameter for the PD for wholesale risk obligors for reporting banks with assets greater than EUR 70b (USD 100b).

Improving the accessibility of Basel Committee documents

We view the Basel Committee's websites as very user friendly and commend the Basel Committee for the approach it has taken. From our perspective no radical change is required. If further improvements are desired the Basel Committee may want to create a comprehensive version of Basel III and may want to provide links to national implementing measures.

Addressing factors driving complexity in a more fundamental manner

The Committee, the EU, regulators and banks have spent considerable amount of time and money on implementing Basel III and will continue to do so in order to ensure compliance. Banks believe that it would be best if the Basel III framework was rolled out in full before any further review took place. Members believe that the having a regulatory capital framework based upon risk is fundamentally correct, and improvements should be made gradually, refining and building-upon the current framework as the industry evolves.

5. Are there other ideas and approaches that the Committee should consider?

Banks believe that regulators have made good progress in revising their approach to banking supervision, for example as set out by the Bank of England on 1st April 2013.[1]

We believe that the current approach and the initiatives that are being taken together adoption of the suggestions put forward in this response would go towards achieving the objectives set out in paragraph 29.

[1] http://www.bankofengland.co.uk/publications/Documents/praapproach/bankingappr1304.pdf

Therefore we welcome the increasing and coordinated efforts with respect to stress-testing the banking systems as well as individual banks. We are pleased to see that regulators are now looking at the structure of banking groups in order to determine how for example "*principal UK-regulated solo entities within these financial groups will be treated as part of the stress testing exercise*"[2].
Banks support the efforts by regulators to establish robust resolution regimes for all significant banks that will when fully implemented contribute to the Committee's objectives.

The Committee will be aware that a number of banks spend considerable time and effort of assessing the PD and LGD of sovereigns and banks and banking groups. Certain regulators have concluded that minimum values should be applied to LGD for these exposures. One area the Committee may wish to look into is the difference between the Standardised and IRB approaches for exposures to Sovereigns and Banks and to provide opinions on whether or not effort should be spent by banks to model uncertain events that are difficult to ex-ante predict and ex-post to validate.

Conclusion

In conclusion, we commend the Committee for consulting on these very important issues. Overall we are of the view that at the present juncture incremental improvements better serve the Committee's overall objectives than radical change.

We hope that you will find our comments useful. Please contact me by way of e-mail (simon.hills@bba.org.uk) or telephone on (00 44) 2072168861 should you require further information.

Yours faithfully,

Simon Hills
Executive Director, Prudential Capital and Risk

[2] http://www.bankofengland.co.uk/financialstability/fsc/Documents/discussionpaper1013.pdf Page 17