



October 11, 2013

Mr. Wayne Byres  
Secretary General  
Basel Committee on Banking Supervision  
Bank for International Settlements  
CH-4002 Basel, Switzerland

Sent by email: [baselcommittee@bis.org](mailto:baselcommittee@bis.org)

**Re: BCBS Discussion Paper – The Regulatory Framework: Balancing Risk Sensitivity, Simplicity and Comparability**

Dear Mr. Byres,

The Institute of International Finance (IIF) and the International Swaps and Derivatives Association (ISDA), hereafter “the Joint Associations,” welcome the opportunity to comment on the *Regulatory Framework: Balancing Risk Sensitivity, Simplicity and Comparability*. The Joint Associations have focused their comments on the ramifications of changes to the current framework for member institutions and the broader financial system, and wish to provide some thoughts on a possible way forward that would capture perceived deficiencies in the risk based framework whilst not jeopardizing the objectives of risk sensitivity and transparency.

Risk taking is at the core of the banking function, which renders the question of reliance on Risk-Weighted Assets (RWAs) one of the most fundamental debates in the post-crisis world. The outcome of the debate has the potential to determine the future of banking, to change market behavior and, as such, to reduce or create systemic risk. Therefore all options for the future of the risk-based framework should be explored in depth before final decisions can be made. The industry feels strongly about the merits of a truly risk-based approach and believes discarding it altogether would be both unnecessary and highly undesirable.

*Maintaining a risk-based framework is key*

We strongly support the BCBS's belief, expressed in paragraph 3 of the Discussion Paper, advocating that a risk-based capital regime should remain at the core of the regulatory framework for banks, a prerequisite for ensuring capital requirements which are commensurate with actual risks incurred, and ultimately leading to financial sector stability.

The industry is highly appreciative of the BCBS Regulatory Consistency Assessment Programme (RCAP) work and fully endorses further RCAP iterations and more in depth analysis of RWA divergence. The industry is equally grateful for having been given an opportunity to provide input to the fundamental and conceptual discussion on the risk-based framework before concrete proposals are on the table.

The emphasis put in the Discussion Paper on striking the appropriate balance between the complementary goals of risk sensitivity, simplicity and comparability is well founded. As the paper points out, not finding the right balance could defeat the objective of producing a sound minimum standard of capital adequacy and the requisite level of individual firm solvency. The ultimate objective of a regulatory framework is to improve the resilience of the financial system. Risk sensitivity, simplicity and comparability are simply tools that form part of the toolkit for achieving this ultimate objective.

While some adjustments to improve the risk-based regime may be necessary, the findings of the RCAP analyses of trading book and banking book RWA show that it is generally working as intended<sup>1</sup>. Both analyses reveal that some differences (most of the differences, in fact, in the case of the banking book) are explained by the idiosyncratic variations in the riskiness of exposures and credit risk mitigation. Analyses by the European Banking Authority (EBA) on European portfolios in the banking book further reveal that at least 50% of RWA variance is attributable to balance sheet structure and choice of Basel approach, and part of the residual variation is driven by differences in the inherent credit risk of the exposures. The remainder is explained by a combination of differences in supervisory approaches and bank modeling choices.

It is therefore clear that both supervisory and bank approaches and implementation practices play a key role in RWA differences. But this, too, is to a large extent an intended consequence of the risk-based framework. As explained in the BCBS trading book RWA analysis, "the Basel standards deliberately allow banks and supervisors some flexibility in measuring risks in order to accommodate differences in risk appetite and local practices;" the question perhaps is whether the current flexibility given is entirely appropriate. In this regard, it is necessary to hold high level strategic, but also more focused, technical discussions covering these issues and to achieve a common

---

<sup>1</sup> BCBS Regulatory Consistency Assessment Programme (RCAP) – Analysis of Risk-Weighted Assets for Market Risk, January 2013; BCBS Regulatory Consistency Assessment Programme (RCAP) – Analysis of Risk-Weighted Assets for Credit Risk in the Banking Book, July 2013

understanding among the various stakeholders of the results of these analyses and their possible policy implications. This is even more important given the oftentimes superficial commentary about the BCBS RWA studies, which tends to focus only on the overall RWA variation percentage upon which the conclusion could easily be drawn that the risk-sensitive capital RWA framework is dysfunctional and that the key driver for RWA variance is attributable to individual bank modeling choices. As is evident from a closer study of the various RWA and regulatory capital model reviews undertaken to far, such a conclusion is unjustified.

The popular belief in the press is that this flexibility affords banks the opportunity and means to manipulate models and/or lower their risk weights intentionally. However, as also highlighted in the BCBS banking book RWA analysis, firms' maneuvering space is actually limited due to

- Imposed parameters, assumptions, floors or any other form of written or verbal supervisory guidance;
- Use test compliance, forcing firms to use the same models and model outputs for external regulatory capital reporting, internal risk and capital management, including, but not limited to pricing and provisioning purposes;
- Rigorous internal and external model validation and approval procedures; and
- By way of risk appetite setting, risk and business management assuming a shared responsibility to contain actual losses incurred with a view to optimizing longer term shareholder returns.

Furthermore, the BCBS banking book RWA analysis demonstrated that judgment-based models did not show a clear positive bias. In fact, the BCBS survey of banking book range of practices found that “banks frequently add (in part due to supervisory expectations or explicit requirements) a margin of conservatism to risk parameter estimates...” In many cases, this extra conservatism may well reflect management judgment as well, as banks assess the risks inherent in different portfolios. In short, contrary to the view often heard in the press, “optimization” of risk and rewards (and hence of RWAs) means in actual fact attempting to procure an adequate, rather conservative and fair estimate of risks and expected and unexpected losses, closely tied to a firm's overall risk appetite and with a view to avoid surprises to senior management and boards.<sup>2</sup>

In this respect, we would like to emphasize that differences in model outcomes at a particular point in time should in no way be construed as proof that there is model bias. For example, for strategic, portfolio or general risk management purposes, a bank might opt for a more volatile, procyclical VaR model while others might apply constant volatility assumptions. This leads to divergence in a ‘point in time’ comparison. However, when assessed over time, (i.e. across a full

---

<sup>2</sup> See for example discussions in the Risk Culture Appendix of the IIF report on *Reform in the Financial Services Industry: Strengthening Practices for a More Stable System*, December 2009; and in the IIF report on *Implementing Robust Risk Appetite Frameworks to Strengthen Financial Institutions*, June 2011.

cycle), there is often substantially less such divergence. Future RCAP studies could shed further light on this factor if the analysis was extended to capture any offsetting differences in the regulatory expected loss deduction that is applied to the capital numerator.

Nevertheless, the industry recognizes that it may be necessary to trade-off some discretion in the way that internal models are deployed to improve comparability. The industry further acknowledges that some level of harmonization of internal modeling and supervisory approaches and practices could be further explored since, if done properly, it might benefit the effectiveness, comparability and transparency of the capital framework without undue loss of risk sensitivity. Disclosure against well-defined benchmarks may prove to be another way to enhance transparency and comparability. The BCBS RCAP analyses have already identified potential ideas in this regard. We welcome further discussion on specific proposals, but at the same time note that benchmarking exercises could bring potential downsides, if and when implemented without due consideration of all angles. We will elaborate on this in Section e. below.

What we consider to be the immediate goal is to preserve and publicly defend the credibility of the risk-based framework in order to maintain stability and certainty in the financial system. In this respect, we urge the BCBS to play a more active part in educating the market on the key drivers behind RWA differences based on its own analysis, rather than simply highlighting the fact that there are considerable differences. It will also be important to correct the frequent, but ill-informed, press and academic assertions that banks “determine their own capital” through the RWA process, and to stress the active and crucial role of supervisors in setting standards, overseeing risk management, and approving and reviewing banks’ risk models, within the context of the rigorous methodological requirements of modern risk management. The role and rigor of internal and external audits and supervisory validations of models and model inputs is sometimes overlooked.

### *The leverage ratio’s claim to simplicity and robustness is unjustified*

We are concerned about the recent attention to the leverage ratio as a possible substitute for the risk-based measure as the sole binding capital constraint, and the misconceptions surrounding the concept. While we discuss below our main concerns on the specific ideas presented in the Discussion Paper on expanding the role of the leverage ratio, first we will address the conceptual notion that it is a “simple,” and hence more desirable, measure.

Oftentimes it is argued that the leverage ratio is simple and transparent, hence easier to understand. However, comparing two banks solely on the basis of the leverage ratio is not meaningful. Two banks with identical leverage ratios could have completely different risk profiles, portfolio compositions and business models, yet this would not be evident to either investors or supervisors on the basis of the disclosed leverage ratio alone. For example, one bank could be providing home loans to highly rated borrowers with low loan-to-value ratios, while another could be lending in the sub-prime and low-doc space with high loan-to-value ratios. Both banks could

have the same balance sheet size and hence under the leverage ratio they would report the same levels of capital, but there is no indication of the relative riskiness of their operations, and so this is a misleading measure of the adequacy of loss absorbing capital. In a similar vein, a retail and a wholesale bank could produce equally high leverage ratios reflecting, respectively, a high proportion in their balance sheets of low risk mortgage portfolios and of OTC derivatives, whilst the risks the two banks present to investors and supervisors are entirely different. In actual fact, without the benefit of the additional information disclosed in the context of a risk based capital framework, supervisors and investors will need to deep dive much more into the specific risk profile of the individual firms in order to capture the riskiness of the firm's operations and balance sheet.

The purported simplicity of the leverage ratio in fact masks real, underlying complexity. It does not provide information on a firm's actual amount of risk taking and hence the adequacy of its capital and, as a result, a high degree of portfolio riskiness or complexity can easily be hidden. It further can create perverse incentives to increase higher risk, higher return assets and avoid lower risk, lower return assets that affect the leverage ratio equally (because there is no reflection of actual risk). The original Basel Accord, with its very broad risk categories, was found to give scope for banks to arbitrage between their economic assessment of risk and capital requirements<sup>3</sup>. This finding was critical in allowing greater alignment of internal risk measures and regulatory capital under Basel II. Making the leverage ratio more binding ignores the lessons learned from the original Accord, and will inadvertently lead to much greater scope for arbitrage than is available under the current capital framework, and even than what was available under Basel I.

Contrary to general beliefs, the leverage ratio is not model-free. Unavoidably, for certain financial instruments, underlying the leverage ratio computation are highly complex valuation and exposure measurement models. Capital adequacy will, in one form or another, revert to risk measurement and modeling of exactly the kinds of exposures that proponents of the leverage ratio seem most determined to revisit.

Further complicating the picture is the fact that the leverage ratio is influenced by relevant accounting rules. To address these accounting differences affecting the proposed Basel leverage ratio, regulators have superimposed their own rules (e.g. on netting, using rules different from both US and IFRS accounting) on top of the accounting measures. In addition, differences in regional banking business models and funding practices – such as greater focus on securitization in the US as compared to retention of assets on balance sheets, either directly or in connection with covered bonds, in Europe – result in a leverage ratio that affects banks differently. The end result is a complex combination of accounting and regulatory concepts, influenced by, but not adequately reflecting, differences of business models and strategies. Understanding this “simple, transparent” measure in a meaningful way will therefore require considerable sophistication on the part of

---

<sup>3</sup> *Capital Requirements and Bank Behavior: The Impact of the Basel Accord*, BCBS Working Paper No. 1, 1999

supervisors and investors. It is not clear to us how primary reliance on the leverage ratio could bring simplicity to the regulatory framework.

Furthermore, we note that the leverage ratio (especially when the LCR requirement to maintain substantial stocks of high-quality liquid assets is taken into consideration) will inevitably constrain credit activities that are relatively low in return relative to the risk that they represent, and this is likely to mean restricted credit capacity for SME lending, trade and project/infrastructure finance, corporate stand-by facilities, and the like.<sup>4</sup>

The risk-sensitive approach to regulatory capital has stimulated a great investment in, and improvement of, internal risk management processes and risk measurement practices. The investment by banks in more sophisticated approaches predates Basel II and should continue. Moving toward a leverage ratio as the sole, or most binding, requirement would however make the business case for continuing to maintain and enhance these systems harder and potentially results in less sophisticated, and less reliable risk management over time than would have been the case if the regulatory capital framework continued to recognize the value of these investments.

As alluded to previously, any business earns its economic profit from taking on risk and charging a risk premium for that risk. A risk insensitive approach could generate a misallocation of resources across the economy, as prices no longer reflect their true economic cost, which could defeat the objective of achieving financial stability.

Particularly given the above comments about the leverage ratio, we are concerned that insufficient thought has been given to how individual banks are supposed to manage themselves in a regulatory environment with a greatly reduced risk sensitive approach. Where supervisors would not tolerate a bank making little attempt to assess and judge the relative riskiness of its activities – to ‘weight’ them according to their respective risks – this is effectively what a leverage ratio would entail, essentially no assessment of the risks. We emphasize that risk management is by its very nature about risk sensitivity. Without regard to different risks assumed there is no ability for any business to earn the appropriate risk premium – and this, in turn, is inherently linked to a bank’s cost of capital. We are therefore concerned that if too much focus is put on simplicity, and its lack of risk discrimination, the end result could be more, rather than less, risk in the system.

In view of the above considerations and in line with the views expressed by some supervisors and academics, the industry believes putting risk based rules and a – properly calibrated and well defined – backstop measure in place is the right way forward. Using the leverage ratio as the sole or the most binding constraint is likely to force capital constraints that do not exist from an economic viewpoint and thus can create a false sense of security.

---

<sup>4</sup> The Associations responded to the Basel leverage ratio proposal separately. The main concerns raised in the leverage ratio response echoed those mentioned in this paper

*Staying the course*

While we appreciate the opportunity to have this debate on the potential future of bank regulatory framework, it should not divert focus from the important task of completing the current Basel III program, in which both the public and private sectors have much invested. Finishing the implementation of Basel III is the most important step that needs to be taken to complete the G20 program to achieve greater international financial stability.

We therefore strongly support the BCBS's view, expressed in paragraph 6 of the Discussion Paper, that full, timely and consistent implementation of Basel III is an important step in improving consistency and comparability of bank regulation globally. The industry has always expressed firm support for the core elements of Basel III, and it continues to do so and indeed has made significant efforts to comply with Basel III, often in advance of the transitional periods granted by the BCBS. Only with full implementation will the most important hurdle to increased comparability be eliminated.

The BCBS approved the core elements of Basel III in 2010 after extensive comments from the industry, academics and other stakeholders. It was viewed at the time, as a direct consequence of the crisis, that further granularity and new metrics were needed to prevent such crises in future. Ignoring all previous discussions and agreements is not only a waste of resources but it also undermines the whole Basel process and, more importantly, it creates uncertainty that is not beneficial to global financial stability. The agreed additional layers of conservatism (including, but not limited to, stress testing and buffers, additional risk categories against which to hold capital, as well as the higher quality and quantity of capital) should be implemented before the need for further measures can be fully assessed. It should be noted that they came on top of conservative adjustments already in place under Basel 2 (i.e., the scaling factor, Pillar 2, Basel 1, downturn LGD and PD floors), such adjustments all contributing to ensuring an adequate level of capital and countering possible model deficiencies.

We appreciate the fact that the BCBS has explicitly noted in paragraph 6 of the Discussion Paper that it has not made a decision whether or not to pursue any of the ideas presented in the paper. The BCBS clearly recognizes the importance and broad implications of the debate, which requires time and extensive research and deliberation before decisions can be made. Individual BCBS members should adhere to this stance and not pre-empt internationally-agreed standards. Uncoordinated policy decisions at the national level will further diminish the consistency and comparability of global banking regulation, which contradicts the spirit of Basel. The industry is highly concerned about the trend to regulatory fragmentation of markets, which goes contrary to the G20 goal of a consistent, efficient, stable financial system for the benefit of a globalized economy.

We would also note that no regulatory system will provide an absolute protection for financial stability. Regulation will always need to adapt to changes in markets as people react to the dynamic environment of their respective economies. It is therefore important that the Basel

Committee reviews its on-going approach to regulation, rather than looking for new ways to fight the last crisis before the previous initiatives and changes have been fully implemented.

1. **Detailed comments on the potential ideas presented in the Discussion Paper**
  - a. **Explicitly recognizing simplicity as an additional objective in all BCBS's policy formulation groups (paragraphs 48 to 49 of the Discussion Paper).**

Simplicity is an intuitively desirable feature of any system, but while the Discussion Paper recognizes the need to strike a balance between the simplicity, risk-sensitivity and comparability objectives, it is important to emphasize that simplicity as a goal should only be pursued where there is a clear benefit in terms of comparability or transparency that fully justifies the loss of risk-sensitivity. Rather than advocating the goal of simplicity per se, it would be better to turn the concept around, and strive for a framework that in addition to supporting financial stability is '*not unduly complex*.' The Committee should be particularly wary of the risk that simpler models provide a veneer of consistency and comparability while obscuring risk based differences.

One of the most important lessons from the financial crisis is that it is critical to continue to measure, manage, and monitor risks in the financial system, and to continuously and rigorously validate, back test and update these practices on the basis of new or expected macro or micro developments. Settling for a very simple metric in order to achieve "simplicity" in the framework ignores this important lesson and the dynamic complexity of today's world.

Risk sensitivity is important to ensure that regulatory metrics align with the economics of a transaction. This enables banks to properly allocate capital to their different businesses, price properly, and make adequate provisions for distressed assets while at the same time allowing supervisors to monitor the relative riskiness of institutions in order to allocate scarce supervisory resources, and allowing investors to seek returns appropriate to the relative risks inherent in different institutions' strategies and business models.

In addition, as noted in paragraph 33 of the Discussion Paper, whilst senior supervisors and senior bank management may prefer a simple framework, the truth of the matter is that both regulatory and bank staff need clarity and consistency in implementing regulations. Simple, conclusive measures may well prove inadequate in the face of complex realities; supervisors and bank risk managers are therefore not necessarily wrong in seeking "increasingly detailed rules to deal with the many nuances and subtleties that banking transactions can involve." In this respect, as stated above, a simple metric not only provides false comfort, but in fact may well require the user to do deeper analysis using other metrics.

Assessing the concept of simplicity also implies considering the operational aspects of implementation from the perspective of the firms. In this regard, we welcome the inclusion of implementation costs (including cost of collection of data and software and analytical support



required) in the list of potential indicators for assessing simplicity in Annex 1 of the Discussion Paper. Indeed, the time and effort required and cost of IT and data development are common themes of industry responses to the many regulatory measures they are in the process of implementing. IT and data requirements are especially problematic where they are specifically mandated for regulatory purposes and are not used for internal risk management purposes, or where different requirements, definitions, or templates are introduced for similar regulations across jurisdictions. The flip side of including such simplicity metrics is that it is difficult to generalize: for instance, extensive internal and external (credit bureau and other) data collection could be required for relatively straight forward retail models making operational costs relatively high, whilst not addressing a cause of undue complexity.

Lastly, the objective of simplicity, if applied with rigor, is incompatible with the notion of a use test. Bank's capital and risk management can never simply just apply the same simple standards where these could misrepresent the bank's actual risks and the potential for losses. Basically, a higher degree of "simplicity" generally leads to a larger discrepancy between external requirements and internal risk measurement. This is alluded to in paragraphs 65 and 66, and requires a more extensive discussion.

#### **b. Enhancing disclosure (paragraphs 50 to 53 of the Discussion Paper)**

The Discussion Paper states that the BCBS will take into account recommendations made by the Enhanced Disclosure Task Force (EDTF). It also proposes disclosures of (1) the results of applying internal models to standardized hypothetical portfolios; (2) both modeled and standardized calculations of regulatory capital; (3) data typically collected by supervisors, e.g. model performance. Furthermore, it is understood that the BCBS has a working group on revision of Pillar 3 disclosures.

We believe that "enhancing" disclosure should not result in a further expansion of the volume of bank disclosure requirements, which would not necessarily be helpful to investors and regulators. Instead, disclosure should be more structured and targeted, and the different strands of disclosure (accounting, EDTF, securities requirements, national stress-test disclosure requirements, etc.) should be harmonized, and duplicative or similar disclosure for similar items avoided. In this respect, we reiterate our stated belief that too much detail could easily lead to losing the big picture. While there is a good argument that better disclosure of the capital requirements for each method used to calculate RWA for each risk class would be helpful to reduce the "black box" stigma to which these measures are currently subjected, the potential benefits of such disclosure for the transparency and comparability of banks' capital accounts must be worked out carefully in consultation with the various stakeholders to avoid undue complexity either for preparers or for

users<sup>5</sup>. In this context, we note that the goal of transparency would be served equally by more disclosure on local applications of the capital standards.

Building on the work of the EDTF, we strongly advocate that disclosure issues be discussed in a tripartite setting, i.e. by inviting the analyst and investor community to the table. This would allow a clear prioritization of relevant changes in disclosure practices and avoid superfluous disclosure.

Applying internal models to standardized hypothetical portfolios has been useful in improving the general understanding of how internal models produce different results but would not produce the kind of structured disclosure that would help external stakeholders form conclusive judgments about how to interpret and compare the internal model-based RWA of different banks. In this particular context, it should be noted that hypothetical test portfolio exercises present certain limitations due to the fact that the hypothetical portfolios do not benefit from relevant expert judgment often used by banks to complement empirical models for real portfolios. This is especially relevant for SME and corporate credit risk models. More generally, models are built around real portfolio data, and using hypothetical test portfolios can never fully mirror an individual bank's reality. Some of the recently undertaken hypothetical portfolio exercises have not been sufficiently targeted, making it difficult to analyze on the basis of the published results alone which aspects created outliers. We recommend, and are ready to actively collaborate on, more granular exercises, which cover non-model standard requirements as well as modeled components.

It is not clear to the industry what is meant by 'standardized calculations' in par. 53. There is a whole spectrum of standardization, ranging from applying and disclosing the current Basel standardized approaches to implementing new standardized, albeit more risk-sensitive approaches (the recently proposed NIMM for counterparty risk) to standardizing parameters and assumptions to be applied by all firms to their internal models. We urge the BCBS to provide clarity.

The industry believes that disclosing calculations according to the existing standardized approaches alongside modeled calculations would not be useful because the two are not comparable and would generate significant (segmentation and other) issues. The standardized approaches are static and relatively risk-insensitive. They are also dissimilar between different jurisdictions (e.g. the difference across jurisdictions with regard to the reference to external ratings). Consideration should in any event be given to making any "standardized" measure used for this purpose more dynamic, i.e. subject to periodic update based on outputs of firms' internal modeling and other sources of market and risk data.

A further concern about the proposed disclosure of "standardized" calculations (in whatever form defined) is that it may feed the perception that the standardized risk weights are more reliable

---

<sup>5</sup> The IIF is responding separately to the Basel liquidity disclosure proposals and accounting disclosure proposals. The IIF is also working with the EDTF on encouraging uptake of its recommendations.

than the internal model based risk weights, i.e. any internal model based risk weight, especially if lower than the standardized equivalent, should be treated with suspicion. This would be a clear misconception, given the relatively low level of granularity, its “one-size-fits-all” approach and the, in some aspects, arbitrary nature of the “standardized” approach, especially in its present form.

There is no easy solution to this problem, but the BCBS might give consideration to focusing on a more harmonized implementation of truly risk-sensitive measures based on rigorously and, to the extent possible, consistently validated and back tested internal models, and help educate the market about how to evaluate the disclosures resulting from them.

We furthermore have concerns about the idea of disclosing data typically collected by supervisors (e.g. model performance), and more in particular on the form and format this may take. Aside from model performance, the Discussion Paper does not really list the other potential information that would be disclosed; hence the proposed idea is quite open-ended. While we believe that, broadly and conceptually, the idea has merit and thus could be explored further in a collaborative effort between the Committee and the industry, it should be avoided to raise confidentiality issues and to disclose information that could impede the effective enforcement of mitigating measures by senior management and supervisors. The latter could have systemic implications, especially during stressful market conditions.

More generally, we believe that the real focus of external stakeholder use of disclosure and investor due diligence should be on understanding individual bank business models rather than on a mere comparison of RWA numbers.

### **c. Using additional metrics (paragraphs 54 to 56 of the Discussion Paper)**

The Discussion Paper proposes a broader set of metrics against which banks can be compared. These could include the current risk-based capital ratios, risk-weighted assets calculated under the standardized approach, capital ratios using market values of equity in the numerator, leverage ratios, risk measures derived from equity volatility, revenue-based leverage ratios, historical profit volatility, price-to-book ratios, asset growth and the ratio of non-performing assets to total assets. The paper further proposes that there should be a standardized suite of resilience measures with standardized definitions and a disclosure template. The Paper states that this would avoid over-dependence on the risk-based regulatory capital framework.

We support the need to avoid over-dependence on individual metrics (including the leverage ratio) as indicators of bank resilience. Rather than basing its judgment and decision-making on an individual number or metric, bank management as a matter of principle focuses on a number of indicators, applies expert judgment, and as such always considers multiple angles. For obvious reasons, supervisors and investors equally do not just evaluate one single metric when judging the financial soundness of a bank. We recognize that alternative market value-based predictors of distress can be useful. However, it is less clear that there is a case for adding these measures to a

bank's existing disclosure obligations on a mandatory basis. Any market participant (or supervisor) that is inclined to do this kind of analysis is already able to source information in a more timely fashion than would be possible via the kinds of periodic public reports that banks produce. Hence, banks might just be required to duplicate information that no one actually uses while the intended users continue to use their own data and calculations.

Whilst market indicators procure useful information, academic research on the use of market based indicators does not produce unambiguously positive results, e.g. spreads can ramp up during periods of market volatility only to revert to prior levels once sentiment improves. In these instances, elevated spreads could overestimate the fundamental risk of individual banks and so in those and other cases market based indicators should at all times be evaluated in conjunction with other metrics and information.

If the BCBS decides that there is benefit in developing a standardized suite of resilience measures for disclosure, such standardized metrics should be aligned where possible with definitions used in other reporting initiatives already in place; and such standardized metrics should replace similar metrics that are being reported to regulators or disclosed to the public. The Committee should avoid requiring disclosure of metrics that parallel similar metrics with different definitions that are reported to different regulators. This will only lead to an undue reporting burden on banks, and, more importantly, may add to uncertainty in the system.

It is important to note that the Joint Associations have always been supportive of the use of standardized definitions for bank reporting and disclosure purposes. Standardization of definitions would ensure more accurate cross-jurisdiction comparisons of banks as well as lessening the burden on systems of banks with cross border operations. In line with conclusions drawn by the EDTF, such fundamental standardization should not, however, lead to rigid, stereotyped disclosures that would not enable management to provide an accurate representation of its view on the firm's risks and results.

We would also note that too much standardization and transparency may very well undermine the objectives of the Basel Committee. It is appropriate for individual banks to take different views of the risk inherent in their activities as there is no one true level of risk that all banks need to converge in. Ultimately, bank management is about managing uncertainties as opposed to quantifiable risks: markets are mainly created by a different view of what likely outcomes are. Disallowing any RWA divergence, or imposing full comparability would undermine the ability of banks (as market players) to hold different views and therefore would affect the system in various, potentially negative ways.

**d. Ensuring the effectiveness of the leverage ratio (paragraphs 57 to 59 of the Discussion Paper)**

Aside from the current Basel leverage ratio proposals, the Discussion Paper puts forward other ideas to “ensure effectiveness of the leverage ratio.” These include (1) adopting a “buffer” structure for the leverage ratio as has been done for the risk-based capital requirements; and (2) the inclusion of stronger leverage ratio requirements for G-SIBs.

The intended role of the leverage ratio under Basel III is to act as a backstop to the risk-based ratio with particular focus on restricting “the build-up of leverage in the banking sector to avoid destabilizing deleveraging processes that can damage the broader financial system and the economy”<sup>6</sup> during periods of stress. The fundamental concern with the ideas reviewed in the Discussion Paper is that they would, if adopted, expand the role of the leverage ratio at the expense of the risk-based measure. For the multiple reasons discussed in our introductory section as well as in our response to the *Consultative Document on the Revised Basel III Leverage Ratio Framework and Disclosure Requirements*, the industry is convinced that a “simple” leverage ratio as the principal regulatory capital instrument would only mask the real complexity of the modern business of banking, in ways likely to lead to new risks and this might ultimately make the economy more crisis-prone.<sup>7</sup>

If incremental capital, or higher margins of conservatism are the underlying objective, they could be pursued more simply and transparently via an increase in the buffers applied to internal model based capital requirements, or by a consistent implementation of (Pillar 2 and other) adjustments. The BCBS and individual supervisors are of course already pursuing this course of action, so pursuing the same outcome via the leverage ratio would appear to add complexity for no unique benefit that is not already achievable under the existing risk-based arrangements.

With respect to the proposed leverage ratio buffer, the concern is that it would effectively just raise the minimum that the market expects banks to comply with, without ensuring the usability of the buffers. This issue of banks feeling the need or required to manage beyond the minimum standards emerged already in discussions on the Basel countercyclical buffer and even with the liquidity coverage ratio (LCR), an issue which the BCBS is still struggling to resolve in a satisfactory manner. More widely, we wonder how the leverage ratio buffers would relate to the capital buffers already established in the risk-based framework, and in particular in Europe, how they would relate to the systemic risk buffers included in the CRR.

Higher leverage ratio requirements for G-SIBs have already been proposed in the US. There is serious concern in the industry that the higher leverage ratios proposed for US banks and bank

---

<sup>6</sup> BCBS Consultative Document on the *Revised Basel III Leverage Ratio Framework and Disclosure Requirements*, June 2013

<sup>7</sup> Peter Sands, “In banking, too much simplicity can be dangerous” *Financial Times*, August 26, 2013

holding companies will have the effect of making the leverage ratio the binding measure under most circumstances, thereby moving away from risk sensitivity and the level playing field. The GFMA/TCH leverage ratio study<sup>8</sup> on the impact of the newly proposed supplemental leverage ratio has revealed that for the majority of banks in the sample, a 3% leverage ratio would already become the binding constraint.

Moreover, it is time for the global regulatory community to consider whether additional measures can be justified, given that many special measures are on the verge of being applied to G-SIBs (i.e., risk-based capital surcharge, more stringent recovery and resolution arrangements, higher large exposure limits, more intrusive supervision, etc.).

The G-SIB capital surcharge is meant to reduce the likelihood of failure of G-SIBs. The more stringent recovery and resolution arrangements are meant to mitigate the systemic impact if a G-SIB failure occurs. It is not clear what a higher, binding leverage ratio would accomplish aside from increasing capital as is already being done in a more discriminating fashion under the existing arrangements.

If the objective is to ensure that G-SIBs have enough capital to absorb losses in the event of failure without the need for taxpayers' funds, the additional Tier 1 and Tier 2 conversion triggers at the point of non-viability, the possible imposition of loss absorbing capacity requirements or bail-in capital, and the cross-border recovery and resolution arrangements being put in place are all geared toward meeting this objective. We believe this is an important issue that needs to be addressed by multi-pronged solutions, and not just by simply raising capital, especially not via the blunt instrument of a risk insensitive leverage ratio. These other initiatives are also better solutions in the sense that they impose the costs of failure on the banks that fail rather than indiscriminately increasing capital for all banks.

Both the Basel capital surcharge and the FSB recovery and resolution requirements leading to a substantially higher proportion of loss absorbent capacity are meant to increase regulatory and capital costs of G-SIBs in order to compensate for the funding benefits that they allegedly enjoyed for being perceived as 'too big to fail'. Other regulations, such as the proposed large exposures framework, also contemplate more stringent treatment for G-SIBs. Special leverage-ratio requirements would come on top of all those measures; however, all of such measures, especially the new resolution framework being put in place under the aegis of the FSB, have already reduced the funding advantages "too big to fail" ("TBTF") firms may have enjoyed before the crisis, and there is considerable evidence that such premium has been much reduced or turned negative<sup>9</sup>, partly as a

---

<sup>8</sup> Global Financial Markets Association / The Clearing House: Responding to the Revised Basel III Leverage Framework – Results of the Basel III Leverage Ratio Survey, September 20, 2013

<sup>9</sup> *Financial Industry Addresses Alleged Large Bank Subsidy*, Policy brief issued the Financial Services Forum, the Financial Services Roundtable, The Clearing House, Securities Industry and Financial Markets Association, and the American Bankers Association, March 2013

result of governments publicly rejecting or severely limiting the possibility of future bail outs. As a result, there needs to be an open debate as to whether such punitive measures, initiated in view of TBTF concerns, are still well founded. If the true objective is to force a reduction in size of large institutions that should be confronted directly, taking into account the arguments for the benefits such institutions bring to the global economy.

**e. Utilizing added floors and benchmarks to mitigate consequences of complexity (paragraphs 60 to 64 of the Discussion Paper)**

The Discussion Paper proposes new or additional floors under internal model outputs based on standardized methods by (1) using the higher of the modeled result or a percentage of the standardized approach; (2) using the higher of banks' own estimates of parameters or regulatory-prescribed parameters; or (3) applying in lieu of hard floors a benchmark measure with disclosure of outputs of both benchmark and model-based approaches.

The Discussion Paper further states that adding floors or benchmarks would (1) limit variation in RWAs; (2) provide additional comfort that banks' risks are adequately capitalized; and (3) make capital ratios more comparable.

Moreover, the Discussion Paper states that while floors may blunt incentives to develop internal models, banks need to develop models for their own risk management and pricing purposes and not just to comply with regulations.

Our comments below distinguish between the use of benchmarks based on a comparison of (real life) internal models and the use of a benchmark measure, which is constructed by regulators independently of internal models, e.g. using a standardized approach. We will first comment on the latter.

Using benchmarks in combination with structured disclosure that explains how internal model-based RWA compare to the benchmark may be a useful enhancement to the Basel III capital adequacy framework, subject to further analysis and reconciliation with the EDTF process.

However, any benchmark relying on the use of standardized approaches without considering sound risk analysis or management would only mask weaknesses and create perverse incentives. Standardized approaches result in arbitrary and potentially flawed capital figures. These problems could be addressed if the standardized approaches were, at a minimum, updated and recalibrated periodically to be more risk sensitive and comparable with internal estimates. We are aware that this is already part of the Basel agenda, and we encourage the BCBS to continue this initiative. However, this approach also has the disadvantage of laying on regulators the higher burden in its supervisory review of making sure that risk estimates are correctly calibrated and updated on a timely basis, that capital reflects the true risk profile instead of putting the onus on banks to keep their risk modeling

and capital adequacy measurement up to date, as is the case with the internal models under Basel II and III.

A more risk sensitive standardized approach however could lead to complexities that may be inappropriate for small banks, which thus may run counter to the objective of producing a framework that is applicable to large and small banks (Discussion Paper, paragraph 29). Hence, if the BCBS decides to use standardized approaches as benchmarks for internal measures, it should consider whether one set of standardized approaches would satisfy both the needs of large and small banks. The fundamental review of the trading book already raised the possibility of two separate standardized approaches. Perhaps a similar discussion should be initiated covering credit risk and operational risk.

More generally, the use of floors is a major concern if they are not deployed in a limited way designed to address concerns the Committee has identified with specific risk based models (e.g. the lack of data points in sovereign risk models). In such exceptional cases, the industry would endorse the application of a floor on a risk parameter; however, even such specific floors could be eliminated over time, i.e. if and when the observed model risk has disappeared or is deemed to be substantially lower. A floor should therefore be subject to sunset clauses so as to periodically revisit their necessity.

The industry has always pointed to the potential for disincentivizing the use and development of internal models if floors are set, especially based on standardized measures. While it is true that banks need to develop risk models for their own risk management purposes and not just to comply with regulations, the argument overlooks the fact that regulations heavily influence business decisions in firms. If the regulator-prescribed standardized measures become more binding than the output of internal risk measures, the latter will lose its influence on business and pricing decisions<sup>10</sup>, potentially leading to perverse incentives, or at the least, less-effective economic risk management. For example, it will make it more challenging for the risk function to communicate to the business functions the need to mitigate risk if risk mitigation (which always comes at a cost) is not adequately reflected in regulatory capital requirements. As another example, banks are unlikely to use Risk-Adjusted Return on Capital ("RaRoc") models based on internal risk models for capital allocation and pricing purposes if the bank's regulatory capital exceeds internal capital to the extent Return on equity ("RoE") is substantially reduced. More importantly we are of the view that there is a serious risk of floors creating a misallocation of resources across the respective economies, as pricing decisions will no longer reflect the economic risk of the underlying activities.

Basing regulatory capital floors on the standardized approach would also pose additional challenges for the BCBS to make sure that the standardized measures are properly calibrated on an ongoing basis. If a regulatory floor based on the standardized measures were to be implemented, the

---

<sup>10</sup> The recent IIF-EY report (*Remaking Financial Services: Risk Management Five Years After the Crisis*, July 2013) found that more banks now are aligning capital allocation with regulatory capital.



implicit assumption is that the standardized measures produce capital requirements that are more reliable and more accurately capture the risks compared to internal models. This will at the very minimum require continuous validation and updating of re-defined standardized measures so to avoid them quickly becoming outdated and insufficiently predictive of a firm's capital needs, and as such, they may even become distortive of risk appreciation or lending incentives or both. Whilst this applies to standardized methodologies used for all risk types, it is most critical for market risk. A lack of timely updates associated with market, product and macro-economic developments in market risk capital approaches can negatively affect market stability.

The cross border comparability of standardized approach outcomes is jeopardized further by considerable differences in local standardized approaches.

Moreover, greater use of "floors" would both blunt the risk sensitivity of RWA and potentially contribute to differences in RWA that undermine confidence in the integrity of the measure. Some of the more extreme risk weight differences observed in the RCAP survey of trading book RWA, for example, appear to be the result of the imposition of implicit floors by supervisors (through the use of higher multipliers), but were widely reported as evidence of the measures being unreliable. Due consideration should be given to the fact that floors could easily end up creating more complexity to the system, and that they invariably introduce cliff effects.

Another undesirable outcome could be that it could be perceived as "curing the symptoms of the disease, rather than the disease itself", and, as such, feed popular belief that internal models are severely flawed. It would be preferable to try to remedy, to the extent deemed possible, the undesirable part of RWA variance rather than to add additional metrics which would muddle the picture and further defeat the objective of transparency.

Applying, as an alternative to floors, the increased use of benchmarks and "enhanced disclosure" in the form of structured reconciliation of internal model based measures against the benchmark risk weights for individual Basel asset classes could contribute to the amount of risk sensitive discretion that we feel should be preserved.

The above comments reflect our reservations about the use of floors or benchmarks based on a standardized approach. On the contrary, as long as it is surrounded with proper governance, representativeness and comparability standards, the use of benchmarks using banks' internal models data can help stakeholders discriminate between banks. The definition, calculation and distribution of risk metrics based on pre-defined sets of exposures can provide a means to understand a bank's risk measures and models and results in a transparent basis for benchmarking a single bank's risk approach to those of other banks and understanding the drivers of differences in bank risk assessments.

We therefore support the idea of regulators or other independent bodies publishing sufficiently granular benchmarked data, provided such data is presented as a range rather than as a single number. The drawback of a binary non-granular approach (i.e. performing below or above the benchmark number) would be for a bank having to defend itself against allegations that its models are fundamentally flawed, such negative perception translating into a response by the markets. For instance, a bank with considerably lower RWA compared to a generic mortgage loan benchmark could be perceived negatively by the markets while its peer bank with higher RWA could be perceived positively. Assuming the first bank's portfolio consists entirely of low LTV, prime first lien mortgages and the peer bank has a subprime or second lien mortgage loan portfolio on its books it is clear how the markets can easily misinterpret outliers, which in fact are fully justified. It would be more useful if the range of risk weights that different banks generated for specific Basel asset classes were made public whereupon banks were then able to explain/justify their internal model based outcome against the range observed.

**f. Reconsidering the linkage between internal and regulatory models (paragraphs 65 to 66 of the Discussion Paper)**

The Discussion Paper raises the question whether the objectives of achieving comparability for regulatory capital purposes and applying strong internal risk management practices are fundamentally compatible. It recognizes that regulatory and internal risk management models should have aspects in common, such as the conceptual foundations and data sources, but may diverge in certain aspects, such as confidence intervals or time horizons.

The Discussion Paper on the other hand raises the need to refine use-test requirements to guard against gaming the system.

The “delinking” idea seems to be founded on the argument that regulatory rules should only serve as a backstop to banks' internal risk assessments, should be independent of such assessments, and therefore should not supplant commercial risk decisions<sup>11</sup>. It further assumes that capturing tail risk and optimizing risk return are unrelated. However, we believe that this is a rather one-dimensional view of the dynamics between internal risk and regulatory measures, and business decisions. As mentioned above, regulations heavily influence the business decisions within firms, as a matter of fact it would be pointless to impose them if they did not. Regulations that diverge too much from internal risk practices may lead to perverse incentives, or may make it more difficult for management to appreciate the actual risk profile or exposures of a firm. This perception was one of the main drivers behind the development of Basel II, and it still remains valid: once again, complexity cannot be wished away, and “simplifying” the regulatory analysis may simply displace some of the risk, or create a danger of certain risks' not being fully recognized, either by

---

<sup>11</sup> The dog and the Frisbee, speech by Andrew Haldane at the Federal Reserve Bank of Kansas City's 366<sup>th</sup> economic policy symposium, “The changing policy landscape”, Jackson Hole, Wyoming, August 31, 2012.

management or by supervisors. Further, the ‘hard’ regulatory capital cost is likely to supplant ‘soft’ economic capital as a key driver for pricing decisions. Finally, a bank not capturing tail risk could influence its risk return in the long run.

When evaluating internal models and external requirements, it is important to distinguish the models used to generate risk estimates like PD, LGD, EAD, correlation assumptions etc. from the model/formula that translates these risk estimates into a capital requirement or RWA. In an ideal world, the former should, as far as deemed possible, be objective evidence-based observations which are back-tested and subject to supervisory validation at least on an annual basis and used as input into both internal and external models / algorithms, while the latter could be adjusted in line with regulatory objectives. These objectives are, among others, to create appropriate macro and micro safeguards and thus are likely to have a more conservative bias. Ideally, there would be more consistency at the global level in this regulatory process.

Regarding the use test issue, we have difficulty understanding and reconciling the comments in par. 65 that internal and external measures might diverge, but that the use test must be strengthened to avoid gaming the system. Whatever the intention of the BCBS, we find that fully delinking internal and regulatory models and refining use test requirements are two incompatible goals. As mentioned above, (over)simplification of regulatory measures is not reconcilable with use test compliance. As the role of internal measures, and hence their influence on the business, is diminished, so too would be the relevance of the use test. A bank’s responsibility towards its shareholders immediately implies the full consideration of (regulatory) capital cost insofar as this cost exceeds internal capital cost. We however do not think that it is the BCBS intention to foist a system on banks that no longer allows them to price business activities according to the risk linked to the activity.

In this context it is important to recall that the use test was originally intended to keep market discipline over the outputs of models. This assumed that internal models indeed reflect losses that are plausible for essentially well managed banks subject to economic stress. However, based on recent experience showing that in a few cases losses far exceeded model outcomes, some supervisors and politicians see the blunt application of more capital to every bank, good, bad or indifferently managed, as the solution to this problem. In our view, the better solution is a combination of supplementary (“PONV”) loss absorbency capacity and effective resolution regimes that ensure that losses are always imposed on market participants, rather than on tax payers, and this allows good banks to operate efficiently while ensuring that the banks that fail the test of good management are the ones that pay the cost.

Regarding the more conceptual discussion on the use of internal models for capital computation, the industry strongly re-affirms its belief that it is the only way forward. As stipulated above, while the BCBS RWA reviews of the trading book and banking book have put forward some ideas to narrow the range of practices, finding the right balance will require further study and debate.

Nevertheless, we believe that a degree of narrowing some of the current variables may be feasible in ways that are reconcilable with the basic goal of reflecting a bank's true risk.

We recognize that, if we are to retain a role for internal models in the regulatory capital framework, then we must be willing to consider foregoing some of the range of choices (both by banks and supervisors) that currently contributes to making comparison of outcomes across banks complex. However, the range of modeling choices by banks should be constrained only in cases where such models clearly lead to biased results and/or unjustified inconsistencies across banks, provided constraining choices does not lead to undue reduction in risk sensitivity.

The latter type of constraint is, on the basis of the BCBS Trading Book and Banking Book RWA studies, going to be much more significant. An example would be making a choice to prescribe through-the-cycle ("TTC") instead of point-in-time ("PIT") estimates: the risk results would average out to be the same over time, although different output numbers would result from time to time). Similarly, standardizing look-back periods, harmonizing the supervisory imposition of model risk add-ons, or the definition of default, could similarly provide methodological normalization benefits without compromising the risk-sensitive reflection of real differences of risk in different profiles or different business models.

In this particular context, we further observe that there is a smoothing effect on the level of capital required through the requirement of an expected loss calculation, which is set off against banks' provisions. It should be noted that banks provisioning is subject to extensive external scrutiny (by external auditors and supervisors). Therefore, even though these so called Expected Loss Best Estimate ("Elbe") calculations are based on the same internal models, the fact that they are to be set-off against actual provisions made, with a possible shortfall taken as a capital deduction item, essentially means that a large proportion of possible shortcomings are already captured.

While supervisors may occasionally identify model choices that tend to bias the process, the most value would come from what could be seen as "normalizing" choices, for example, picking either TTC or PIT measures, to remove the differences apparent on any given day, even though a bank's risk assessment using one or the other should average out over time. The industry stands ready to identify the "low-hanging fruit", i.e. to propose areas where normalizing choices could improve the risk-based framework without undue loss of risk sensitivity.

To clarify the above point, strict harmonization of parameters, other than those that can be "normalized" on a well-understood and widely applied basis, should not be the goal since a too rigid imposition of standardized assumptions or definitions would undermine risk sensitivity, increase model risk across the industry, result in herd behavior in the markets, and make it more difficult to implement the use test in a meaningful way. Model harmonization would also lead to a higher correlation in banks' capital requirements and resulting business incentives, which may lead to procyclical effects. This concern has also been raised in the BCBS trading book analysis, which states

that “it is desirable to have some diversity in risk management practices so as to avoid that all banks act in a similar way, which potentially could create additional instability.”<sup>12</sup>

Harmonization or convergence of processes and practices associated with the internal models approaches should therefore not be misconstrued as model standardization.

**g. Limiting national discretion and improving supervisory consistency (paragraphs 67 to 69 of the Discussion Paper)**

As stated above, we do recognize that it may prove vital to trade-off some of the range of application of internal models in order to make it easier to identify and understand the differences in RWA that the models produce, and therefore to confirm that these differences are legitimate reflections of differences in the risk of different portfolios. However, as acknowledged in the Discussion Paper, it is equally important to harmonize supervisory practices pertaining to the implementation of internal capital measures across jurisdictions. The BCBS trading book and banking book RWA studies already outlined some preliminary ideas in this regard, and the industry stands ready to support further work.

The ideas outlined in the BCBS trading book and banking book RWA studies include harmonizing supervisory practices and national implementation requirements, narrowing banks’ modeling choices for the trading book (e.g., closely defining the modeling approach for the IRC model, reducing flexibility in choosing the length of historical data to calibrate VaR models, defining a single scaling approach to obtain 10-day VaR and stressed VaR measures), and additional guidance or benchmarks for IRB parameter estimates (e.g., additional guidance on the use of external data for low-default portfolios, representative PD estimates for particular rating grades or for other indicators of credit quality, representative LGD estimates for various types of exposures, representative Credit Conversion Factor (“CCF”) estimates based on observed bank practices). These ideas, however, need further study to find the right balance between comparability and risk sensitivity as the representativeness and usability of such data for an individual bank’s portfolio is often questionable. In addition, any idea that would be pursued should aim to preserve the effectiveness of internal models at identifying the relative riskiness of different exposures and portfolios, while adding methodological normalization and benchmarking to avoid differences in results across banks that are difficult for outsiders to understand.

The Discussion Paper mentions that the BCBS is currently undertaking a review of current national discretions to assess the need for, and extent of, their use. To the extent national discretions remain necessary, the Discussion Paper also proposes that a database of their use could be developed and published as an aid to comparison.

---

<sup>12</sup> BCBS Regulatory Consistency Assessment Programme (RCAP) – Analysis of Risk Weighted Assets for Market Risk, January 2013

This database would indeed be very useful and its development is strongly endorsed by the industry. The data would be even more useful if supervisors were required to acknowledge how the exercise of national discretion compared to BCBS minimum requirement and similar exercises of national discretion by other supervisors, and to explain the rationale for the exercise of national discretion. In addition, banks should be permitted to disclose how their capital calculations under their applicable national requirements compare to such calculations under Basel III as adopted by the BCBS.

In addition, in order to further improve supervisory consistency, and therefore reduce a significant source of variation of RWAs as identified by the BCBS analyses of banking book and trading book RWA, the BCBS should agree on clear implementation standards for the Basel rules, particularly on model assessment and approval, to guide application of the rules by the different national supervisors. Areas such as imposed capital add-ons for model risk or conservatism, and their application in Pillar 1 or 2, required (length of) data series, etc. are examples where harmonization of supervisory practices could perhaps be achieved. All this will narrow supervisory practices and help improve comparability of regulatory capital. We understand that this may be one of the outcomes of the BCBS RCAP, which we fully support.

#### **h. Improving the accessibility of Basel Committee documents (paragraph 70 of the Discussion Paper)**

The Discussion Paper mentions that the BCBS has initiated a process to consolidate all the standards into a single, accessible, structured set of documents. This will be supplemented by improvements to the BCBS website, designed to make the standards easier to find, navigate and understand.

The industry commends the BCBS for the accessibility and ‘user friendliness’ of the BCBS Basel II and III documents, and wishes to express its appreciation for this fact.

The proposal to make them even more accessible and structured would be very useful and the industry encourages the BCBS to pursue this initiative. The industry would encourage, as a further step in this process of transparency, that local implementations of Basel III be accessible in similar formats and/or that links be established by the BCBS to those local documents.

#### **i. Addressing factors driving complexity in a more fundamental manner (paragraphs 71 to 77 of the Discussion Paper)**

The Discussion Paper states that there may be value in reassessing the relative balance given to each of the three pillars of the Basel framework. As noted below, the IIF has always supported strengthened supervision and not just rules-based regulation, particularly in areas where consistent

implementation of prescriptive rules is quite challenging and may result in unintended consequences. For example, most recently we have advocated a Pillar 2 approach to recognizing the cost of credit protection purchased and assessing economic interdependence for large exposures purposes. In a similar vein, the Institute also supports the goals of the BCBS's reconsideration of Pillar 3 disclosures, which need to be made more useful and more coherent with other supervisory, securities, accounting and EDTF disclosures.

The Discussion Paper also outlines a number of fundamentally different approaches to capital adequacy that could be explored in the longer term. These include (1) tangible equity (using only tangible equity as a measure of capital and tangible assets as a measure of risk); (2) a leverage ratio and a standardized approach (disallowing the use of internal models altogether for regulatory purposes); and (3) pre-commitment approaches (banks could be required to commit to keep capital above a threshold multiple of their measured income volatility). The first and third of these concepts need considerably more research and analysis to be discussed adequately; the second is subject of extensive debate in other fora, so we will give here only a summary analysis of what essentially are rather complex concepts with potentially far-reaching consequences. Such summary discussions should not distract from the need for very wide analysis and debate before any of these ideas could be taken forward.

As a general observation, we note that this drive to reduce complexity implies a sea change compared to the direction that was taken until very recently by regulators and supervisors requiring banks to have more granular and differentiated risk measurement systems in place – sometimes even to the point of fully capturing immaterial risks and portfolios. Balancing the increasingly granular requirements imposed on banks and the desire to reduce undue complexity should be done, at a minimum, by applying the principles of materiality and proportionality, and by carefully weighing the merits of simplicity against those of enterprise-wide, comprehensive risk management.

The concept of tangible equity vis-à-vis tangible assets basically reflects the approach used prior to the original Basel Accord, which was deemed deficient. This approach would exclude off-balance sheet exposures, which would in turn incentivize banks to turn to off balance sheet ('OBS') transactions. As noted in the BCBS's 1986 paper outlining the ideas behind the credit conversion factor ('CCF') framework for OBS assets, the prime motivation for some OBS innovations before Basel I had been the avoidance of capital requirements<sup>13</sup>. Moreover, as the Discussion Paper notes (first bullet of paragraph 75), this approach would "vastly reduce ex ante risk sensitivity in the capital framework and places much more importance on effective supervisory practices to maintain bank safety and soundness." It would obviously put great strain on supervisory resources in the post-crisis environment, and undermine the G20 goal of globally consistent regulation. Hence, it is not clear to us why reverting to this approach is envisioned at all.

---

<sup>13</sup> BCBS, *The Management of Banks' Off-Balance Sheet Exposures*, March 1986

On the use of the leverage ratio in combination with a standardized approach, we already argued above that if risk insensitive measures become more binding than internal risk measures, this could lead to a false sense of security, misleading comparability, and even perverse incentives. Using a leverage ratio and a standardized approach whilst discarding the internal models approach would not “preserve the belt and suspenders” approach of Basel III. The Basel III solution of a back-stop leverage ratio allows regulators and industry to continue to develop risk-sensitive risk management as an appropriate basis for prudential capital requirements. Combining a leverage ratio with a standardized approach would however be a gigantic step backwards because it would combine two rigid, largely arbitrary measures that have no hope of reflecting actual risks, actual differences of risk appetite and risk profile, or actual differences in business model.

Pre-commitment approaches hinge on very strong simplified assumptions, i.e., that we are constantly in a steady-state in which risk circumstances, volatility and correlation are constant. As the recent crisis has shown, this is quite obviously not the case. Prior to the crisis, income volatility from senior tranches of mortgage-backed securities, for example, was quite low for a protracted period of time. This however masked the underlying conditions at that time (e.g., poor underwriting standards, rating problems, pricing bubbles, etc.), which all unraveled during the crisis. One way to address this would be to impose a very high multiplier to the volatility measure. However, the higher the multiplier, the less meaningful volatility becomes as a risk measure to guide business decisions, and the more potential there is for unintended consequences or over-correction with consequent impacts on lending capability.

The Discussion Paper further mentions possible measures to reduce future banking risk and complexity, such as (1) placing supervisory controls on the pace of development of highly complex and innovative financial instruments; (2) restricting activities that are not designed to promote traditional customer-oriented banking business; and (3) improving bank resolvability and reducing global and domestic interconnectedness.

We are concerned about the implications of some of the ideas put forth in this part of the Discussion Paper. While these points are stated to be beyond the “direct” remit of the Basel Committee, mention of them in this context calls at least for some preliminary comment.

Placing supervisory controls on the development of complex and innovative instruments would require a great deal of thought and debate. Among other things, the proposal seems to blur the traditional distinction between prudential regulation and product regulation; it could create moral hazard by implying that innovative products developed under supervisory “controls” had an authoritative seal of approval and it would substitute supervisory judgment for market responsiveness in innovation in a quite novel way, apparently not requiring demonstration of any particular market failure (which is the traditional justification for regulatory intervention). Equally important is that it would risk putting obstacles in the way of appropriate responses to changes in



markets or end-users' needs. Markets and economies are evolving and as a natural consequence customers' financial needs could alter as well.

“Restricting activities that are not designed to promote traditional customer-oriented banking business” implies certain political choices about the purpose and structure of banking systems that have hitherto been considered to be within the sovereign discretion of national jurisdictions, and indeed are being hotly debated in many countries. While there would be some appeal to having international harmonization of such structural choices, the pros and cons of such harmonization clearly require a great deal of consideration and debate.

The industry has strongly supported efforts to improve bank resolvability,<sup>14</sup> and we note that there are already measures in place or being proposed to measure, monitor and address interconnectedness (i.e., G-SIB surcharge, recovery and resolution arrangements, FSB common data template, large exposures framework, FSB work on shadow banking, creation of official sector agencies that specifically deal with systemic risk, etc.). It is not obvious what additional measures should be taken to address those issues, and the better course would be to concentrate on the international cooperation and coordination that is still needed to make those measures fully credible and effective.

## Conclusion

The industry views the retention of a truly risk-based capital framework a key factor in achieving and maintaining financial stability. If the BCBS objective is to build in a higher degree of comfort and/or for banks to hold more capital, it is important that this be pursued transparently via higher targets (ideally via buffers), rather than via less risk sensitive measures of capital.

Comparison to and, if required, calibration against international or local benchmarks is another potential tool that, provided it is implemented with the requisite pre-conditions and caution, would allow banks to retain the relative risk sensitivity of their internal models while still having overall outcomes that make sense on a relative comparison basis.

Enhanced disclosure, both by banks and by their supervisors, is a good starting point which should already lead to an outcome where differences are transparent and either validated in the face of market scrutiny or revised to the extent that the differences can't be fully justified.

External stakeholders should be fully aware that standardized or leverage ratio based capital approaches give the appearance of comparability and robust conservatism, but in actual fact are not model free themselves, may obscure a firm's true risk profile, and do not procure the coveted level of (cross border) comparability.

---

<sup>14</sup> See, e.g., IIF report on *Making Resolution Robust – Completing the Legal and Institutional Frameworks for Effective Cross-Border Resolution of Financial Institutions*, June 2012

For financial stability almost as important as finding the appropriate balance between risk sensitivity, simplicity and comparability is that policy makers express their firm belief and trust in the ultimately chosen risk-based framework. Only then will a capital framework be in place that is generally perceived as credible and which will prove sustainable in the long term.

The roadmap towards this goal could be composed of the following consecutive stages:

- Full implementation across the globe of the Basel II and III standards
- Completion of the RCAP and equivalent RWA related exercises by way of analysis of asset classes, which so far were not included, and with greater granularity and assessment of drivers. The RWA analyses should include both the internal modeling practices and the supervisory requirements and intervention at various stages in the model approval process;
- A comprehensive analysis of Basel II and Basel III layers of conservatism and model risk add-ons, to be held against the need to put in place safeguards against possible deficiencies in the capital standard. In due course, we hope that the BCBS will consider progressively replacing the conservatism currently built into RWA measures with higher target ratios should that conservatism still be deemed necessary;
- A focused review on how modeling could be changed to achieve a higher degree of harmonization and convergence and, as such, to better align with the BCBS objectives of transparency and comparability;
- A cross regulatory analysis of the capital standard with other regulations and standards including, but not limited to, the leverage ratio, the FRTB, and the new accounting impairment regimes;
- Subsequent revision of modeling practices by the industry and supervisory evaluation of the outcomes against the desired harmonization objective.

The Joint Associations stand ready to support the BCBS in all of the aforementioned stages.

Sincerely,



**Kevin Nixon**  
Managing Director, Regulatory Affairs  
*Institute of International Finance*



**George Handjinicolaou, Ph.D**  
Deputy CEO and Head of ISDA  
Europe, Middle East and Africa  
*ISDA*