

POSITION PAPER



WSBI-ESBG response to the BCBS consultation on capital floors: the design of a framework based on standardised approaches

WSBI (World Savings and Retail Banking Group)

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ESBG Transparency Register ID: 8765978796-80

March 2015



WSBI



ESBG



Dear Sir/Madam,

Thank you for the opportunity to comment on the EBA consultation on *capital floors: the design of a framework based on standardised approaches*.

General comments

According to the consultation, two of the BCBS's major aims for the proposed floor framework are to "improve comparability by providing a standardised assessment of risk which can be compared against internal model-based outcomes" and "constrain variation in model-derived risk-weighted assets (RWAs) that arises from differences in bank and supervisory practices, thereby improving the comparability of RWAs across banks and over time".

WSBI-ESBG doubts that these goals would be fulfilled through the proposed floor framework. This is because the standardised approaches, both the current versions and the proposed revised versions, do/would not result in consistent and comparable risk measures, especially not when comparing risk weights calculated on exposures in different jurisdictions. In addition, we believe that the proposed framework on capital floors would remove a significant part of the benefits with the risk-based capital models, e.g. the risk-based internal steering in banks, risk-based pricing of lending and an efficient allocation of bank loans provided to the real economy.

According to WSBI-ESBG's view, measures aiming at correcting identified deficiencies in the risk- and own models based capital adequacy framework would be a better way to reach the BCBS's aims and reinvigorate trust in the framework, than to introduce new capital floors based on the standardised approaches. Diversity of the models is also desirable from a banking supervision point of view since it will reduce the systemic risk that otherwise may occur if all banks are affected simultaneously by the same measurement error, because they use similar models. In this respect, WSBI-ESBG would like to emphasise that in case floors based on standardised approaches are introduced, strong incentives for using the internal procedures should remain. Accordingly, the floor should be just a percentage of the equity capital requirements in accordance with the standardised approach, which should be as low as possible.

The models-based approaches for capital adequacy measurement introduced by the Basel Committee, for market risk in 1996 and for credit risk and operational risk in 2004 (although the implementation in EU legislation did not occur until 2007 and even later in the USA), was a major step forward which triggered a process that has significantly improved banks' and supervisors' understanding of risks. WSBI-ESBG therefore believes that it would be important to maintain – and further develop – this framework. In case the framework is deemed to result in insufficient capital requirements for certain exposures, the most adequate reaction should be to reform the framework by a stricter regulation of risk assessment methods and to further develop standards for recalibrating the risk weights, when needed, rather than cutting away risk sensitivity from the framework by introducing floors.

Furthermore, the BCBS is currently consulting on the review of the SA and we fear that the combined effect of capital floors and the new developments in the design of the SA will in practice limit the role of internal models approaches both in terms of costs – keeping in mind that the two systems (standardised approaches and IRB models) would have to be in motion at the same time – and benefits. In this regard, WSBI-ESBG would like to emphasise the importance of continuing to build the risk framework based on the use of internal models as they provide a more risk-sensitive result when calibrating risks.

Indeed, WSBI-ESBG holds the view that capital floors based on the standardised approaches might provide a false sense of exactness and reliability. In reality, they might rather introduce arbitrariness in



the capital adequacy framework. The reason for this is that standardised approaches themselves might not provide risk measures which are internationally comparable. This is most striking in the case of the proposed review of the standardised approach for credit risks. According to our view, the proposed two-factor models for determining risk weights in the revised standardised approach are neglecting a lot of relevant information: information which, in a natural way, is taken into account when individual banks are modelling their risks and which is necessary in order to arrive at a relevant risk assessment. As a consequence, credit exposures like e.g. residential real estate exposures, in, for instance, countries like Germany, France and Sweden, on the one side, and the USA, on the other side, having a certain LTV (e.g. 70%) will be regarded as posing the same risk of loss although the historic loss patterns for residential real estate exposures in these countries tell a completely different story. In our opinion, the same goes for the models chosen for corporate exposures and exposures to institutions. In addition, WSBI-ESBG also believes that the risk of loss on retail exposures may vary significantly between different groups of exposures included in this category and between jurisdictions. This will be captured by banks' models based assessments but is completely ignored by the standardised 75% and 100% risk weights proposed in the new framework.

What is more, WSBI-ESBG fears that the proposed framework could significantly disturb the credit intermediation process, which is very important in Europe for the recovery from the crisis.

In WSBI-ESBG's mind, an incentive should be maintained to use internal models for Pillar-I purposes to promote, and not impede, the further development of bank-internal risk measurement and management systems. Reasonable regulatory incentives, such as the introduction of the IRBA under Basel II have led to clear progress in banks with respect to the quality of quantitative credit risk measurement and credit risk control. Disciplining, and hence improvement in terms of data collection and data quality, has also contributed to clear progress in risk management. The close coupling between internal control and determination of the capital requirements is a valuable achievement which should not be abandoned.

We therefore ask the BCBS to reconsider the floor proposal, and instead focus on reforming the internal models approaches in a way that maintains the risk-sensitive own models approaches. Indeed, sufficient leeway should remain for the banks to apply different internal procedures. This would enable them to check – within the framework provided by supervision – different procedures in competition, which would promote the continuous improvement and development of these procedures. Moreover, excessive standardisation might lead to banks behaving uniformly in a stress situation (herd behaviour). This entails risks for the stability of the financial markets and should therefore, from a banking supervisory point of view, be weighed up against the advantages of a higher level of standardisation.

What is more, WSBI-ESBG would like to point out that the EBA has clearly acknowledged the fact that for non-low default portfolios the IRB approach has proven to be the best approach: “The review of the IRB framework should take into account the experience gained in recent years. It seems clear now that for some portfolios, in particular for retail and SME exposures, the IRB approach is the most appropriate option as the risk parameters are usually estimated with high accuracy and the risk management processes are significantly improved by the use of this approach” (Future of IRB approach (EBA/DP/2015/01), Para. 169). Therefore, any reference to putting a floor based on a non-optimal approach under portfolios that are proven to be best managed under the IRB approach is not in line with the logic of sound risk management.

Lastly, the practical implementation of the capital floors still leaves some unanswered questions:

- How to incorporate the floors in the institutions' sourcing/processing;
- How to deal with changes in exposure classes due to in- and outflow of asset classes;
- How to cope with calibration differences between retail and commercial banks.



Question 1: Assuming the respective floors were calibrated to achieve the same level of required capital, what are your views on the relative merits of a risk category-based floors and an aggregate RWA-based floor? What are your views on a floor based on exposure class?

At this stage, where it is only stated that the BCBS intends to have (a) capital floor(s) based on new standardised approaches in place, but without suggesting the actual calibrations of the floor, it is very difficult to fully assess the different types of capital floors and consequently make a choice. For example, the introduction of exposure class or risk parameter floors in credit risk may change the perspective of banks on the choice the two types of floors.

Nevertheless, in spite of not having all the information needed, WSBI-ESBG rather has the tendency of favouring an aggregate capital floor. It is our impression that it could be less complex to manage aggregate floors in contrast to risk category-based floors. Furthermore, they seem to deviate less from the (former) Basel I floor.

However, we would like to reiterate that the final position depends on the calibration of the floor as well as the outcome of related regulatory changes to the approaches used for different risk types (both in terms of internal models and standardised approaches).

Question 2: What are your views on the relative merits of the two options for adjusting for differences in the treatment of provisioning for credit risk?

WSBI-ESBG believes that both variants of calculation of the shortfall (between the provisions for risks on the balance sheet risk provisioning and the expected loss determined under banking supervision regulations) are associated with challenges:

Option 1, in which the regulatory capital basis is adjusted, can in our opinion not be calculated at the claim classes level, because this would require that the capital basis be assigned to individual claim classes. This would lead to additional complexity in this variant.

Another complex factor is the calculation of the floor on the basis of all quotas, because different capital components are taken into account for each capital class under both the IRB and the credit risk standardised approach. We believe it is debatable whether even more adjustments should be made to the capital definitions, which are already highly complex. Moreover, from our point of view, the question arises whether, when adjusting the CET1 due to the shortfall, the appropriate subsequent threshold value deductions (DTA, equity investments in companies of the financial sector) are to be taken into account and adjusted.

Since, in addition to this, the regulatory capital basis forms the basis for other regulatory indicators as well, it should also be borne in mind that an adjustment of the capital would, for example, require an adjustment of the leverage ratio.

Option 2 at first glance seems to be somewhat more intuitive, but WSBI-ESBG believes a crucial weak point is that capital components taken into account in tier 2 capital are taken account of in the RWAs in the same way as capital components taken into account in tier 1 capital. A result of this may be that banks, on the one hand, want to avoid the formation of "general loan loss provisions" or, on the other, the reporting of an excess in the value adjustment comparison.



Question 3: Do you have any other comments regarding the design of the capital floor?

Generally speaking, it is WSBI-ESBG's opinion that capital or risk weight floors or other kinds of highly standardised capital requirements should only be used when the circumstances are such that there is a high risk that quantitative models will not be reliable, e.g. due to shortage of relevant data or rapid and significant structural change which makes history a less valuable guide into the future.

WSBI-ESBG would also like to underline that numerous regulations, such as the Basel III capital and liquidity frameworks, have been introduced since the last financial crisis. They have made the banking sector more resilient than it was ever before. In addition, the total loss absorbing capacity (TLAC) and the minimum requirement for own funds and eligible liabilities (MREL) will complement the already existing capital framework. This further strengthens our view that the BCBS should (re)consider whether to implement new capital floors on top of the legislation already passed and before having had time to assess the stabilising effects of the already-established regulatory prudential framework. Hence, WSBI-ESBG doubts the need or appropriateness of adding another complex layer of regulation through new capital floors.

Furthermore, WSBI-ESBG encourages the BCBS to avoid introducing capital floors based on standardised approaches until all other regulatory standards that are still missing are in place. An overall impact assessment could then be carried out so as to better understand the impact of such a capital floor. Among all the measures that regulators are developing or implementing, the most important ones to consider are:

- QIS exercises and finalisation of the standardised approaches for credit risk and operational risk;
- Upcoming new standards on interest rate risk in the banking book (IRRBB);
- QIS and final standard for the TLAC;
- Finalisation of the review of the SA for market risk;
- Revisions to the internal models methods for credit, market and operational risk;
- Revisions to the treatment of sovereign exposures;
- Revisions to the calibration of the leverage ratio.

We, therefore, suggest that the time schedule for the introduction of the floor be harmonised with the time schedule for the introduction of the standardised approaches and other relevant regulatory initiatives. In particular, we find it is indispensable to calibrate the floor only once all standardised approaches have been finalised, to enable full consideration of the interdependencies.

With regard to the calibration of the floors, we understand from rumours and informally provided information that the committee discusses floor levels in line with the current Basel I floor or higher. Moreover, WSBI-ESBG has the impression that it is the BCBS's intention that the new permanent capital floor should, in contrast to the current EU legislation regarding the transitional Basel I floors, become an integral part when defining a banks risk exposure amount. If the BCBS takes this approach, the new permanent floors will have a direct impact on the minimum and the buffer capital requirements, and they will actually become a system of risk weight floors rather than capital floors. This must be taken into account when calibrating the new framework. Otherwise the new approach would lead to the result that the actual effective floor level is likely to be significantly increased in the EU and at risk of completely deleting the risk-based approach for low-risk retail portfolios as well as retail banks primarily focused on low-risk lending to the real economy. According to WSBI-ESBG's view, the proposed floor framework is hence, if implemented and calibrated without taking the current EU legislation regarding the Basel I floor into account, likely to trigger an unfortunate development away from risk-based steering in banks and away from risk-based pricing and allocation of lending to the real economy.



Apart from that, WSBI-ESBG recommends not overlooking the close links with the rest of the Basel III framework, which already contains a backstop on capital through the leverage ratio. The only reason for maintaining a floor in a framework in which a floor on capital already exists, would be to curb undesirable RWA variability. For the same reason, the EBA is starting a process that can end up with a whole revision of the IRB system. If the BCBS holds on to the floor proposal, we propose that the floor(s) should be explicitly defined as a RWA-backstop (to help harmonise RWA for similar risk) in line with the implementation of the transitional Basel I floor in the current EU legislation. In addition, the interaction of a floor with other changes to the internal models-based framework needs to be considered, in particular any constraints and/or limits on individual risk parameters (e.g. PD and LGD) that are currently under discussion.

Moreover, we believe that the BCBS should be careful when aiming to “enhance the comparability of the capital outcomes across banks” through new capital floors. We have doubts whether such floors have the ability to be sufficiently sensitive to the specific risk profiles of different institutions and the specificities of the various national jurisdictions. It is therefore doubtful whether the results will actually make capital outcomes more comparable vs. making them more similar, while actually masking real underlying differences in risk profiles. Nonetheless, WSBI-ESBG would like to hold that it is important that, generally speaking, the same basic methodologies are applied for the calculation of key requirements, such as the capital ratio. At the same time, however, the crucial and necessary risk sensitivity must not be cut away. In order to achieve a level playing field, it is important to apply a harmonised risk measurement as a basis for harmonised capital requirements. The latter cannot be attained unless the first is in place. The only way to achieve this is through a coherent implementation of revised floors (if introduced).

As described above, the new floor framework proposed by the BCBS is likely to significantly increase the associated capital requirements in EU in comparison to the current transitional Basel I floor. For some of our members, in which low-risk retail lending dominates their business and balance sheets, the new higher capital requirements could create strong incentives to increase interest rate margins on lending to their, from a risk perspective, best customers. This is likely to have a negative impact on the macro-economic development in their home markets. For these members the new framework may also create strong incentives to sell off low risk credit volumes to non-banks not affected by the new requirements, e.g. through securitisations. This would in the long run make the credit market less resilient, if a new crisis occurs, since the new non-bank actors in the credit market are likely to feel less committed than the banks to provide finance in turbulent times.

Furthermore, the additional calculation of the capital requirements in accordance with the standardised approaches, which would be necessary for checking the floor, would cause substantial additional expenditure in the banks.

Last but not least, WSBI-ESBG would like to request a sufficiently long implementation period (phase-in arrangements) in case revised capital floors are to be introduced, since the impact is likely to become significant, in particular in the EU. An appropriate implementation period would not only be fundamental for process but also for mitigation actions.



About WSBI (World Savings and Retail Banking Institute)

WSBI brings together savings and retail banks in all continents and represents the interest of circa 6,000 financial institutions with total assets of USD 14 trillion and serving some 1 billion customers in 80 countries worldwide (2013 figures). As a global institution, WSBI focuses on international regulatory issues that affect the savings and retail banking industry. It supports the aims of the G20 in achieving sustainable, inclusive and balanced growth and job creation around the world, whether in industrialised or less developed countries. WSBI favours an inclusive form of globalization that is just and fair, supporting international efforts to advance financial access and financial usage for everyone. It supports a diversified range of financial services that meet customers' transaction, savings and borrowing needs responsibly. To these ends, WBI recognizes that there are always lessons to be learned from savings and retail banks from different environments and economic circumstances. It therefore fosters the exchange of experience and best practices among its members and supports their advancement as sound, well-governed and inclusive financial institutions.



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About ESBG (European Savings and Retail Banking Group)

ESBG brings together savings and retail banks of the European Union and European Economic Area that believe in a common identity for European policies. ESBG members support the development of a single market for Europe that adheres to the principle of subsidiarity, whereby the European Union only acts when individual Member States cannot sufficiently do so. They believe that pluralism and diversity in the European banking sector safeguard the market against shocks that arise from time to time, whether caused by internal or external forces. Members seek to defend the European social and economic model that combines economic growth with high living standards and good working conditions. To these ends, ESBG members come together to agree on and promote common positions on relevant matters of a regulatory or supervisory nature.

ESBG members represent one of the largest European retail banking networks, comprising of approximately one-third of the retail banking market in Europe, with total assets of €6,749 billion, non-bank deposits of €3,415 billion and non-bank loans of €3,685 billion (31 December 2013).



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