European
Banking
Federation

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Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of some 4,500 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU alone.

EBF response to BCBS discussion paper "The regulatory framework: balancing risk sensitivity, simplicity and comparability".

The EBF welcomes this opportunity to participate in the current debate on the balancing of regulatory objectives and it stands ready to discuss its arguments if and when the current prudential regulatory framework is adjusted.

The banks represented by the EBF have shown the highest degree of commitment in the implementation of the Basel Accord in its various stages of development, in particular the more advanced version of Basel II. The acceptance of European banks was unhesitating. Vast resources have been invested since. We believe the enormous contribution of the developments that Basel II brought about is a valuable asset of today's banking sector. It ought to be used in the difficult task of leading the banking business under well-informed management and supervision.

In the general remarks section we start off by setting up facts and ideas that should be regarded before getting down into the answers to the five specific questions of the BCBS discussion paper.

GENERAL REMARKS

Part of the solution

When the financial crisis erupted in July 2007, Basel II and its internal risk models for regulatory capital calculation were still in preparation for a start in 2008 whereas the simpler Basel I regime was in place. The overwhelming effects of the crisis have cast a shadow over the merits of the current regime but the truth is that Basel II has not created the crisis. Instead it has provided all stakeholders with valuable information and tools that otherwise would not have been available and thus continues to support financial stability. Internal risk models can serve to align lending practice towards economically beneficial activities. The EBF would argue that models are part of the solution, not part of the problem.

Basel II is the result of the expertise and knowledge of the global banking sector stakeholders including regulators, supervisors, bank employees and academics from across the world. It is the

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best that the banking sector community has been able to deliver in terms of prudential standards. It must be sound, even though certain parts may need to be reviewed or complemented.

The EBF agrees that the performance of the Basel III accord should be regularly monitored and adjusted accordingly. However, the EBF does not share the presumption that an overhaul is required. As a result, the EBF would recommend that policy makers look at specific items of the current framework that could improve without putting in danger the benefits associated with the rest.

The broader picture

The analysis of the current standards for capital requirements has to be put in the context of the broader present regulatory framework and the measures under implementation including the enhancement in the quality and quantity of capital, the roll-out of liquidity monitoring ratios, the systemic risk regime, the recovery and resolution plans under development and the expected progress in the area of improved supervision.

Against this background, the EBF believes that it is important to convey a message of confidence in the current framework with all its upcoming complements.

The EBF recommends not to shake up fundamentally the current framework during the build-up of the abovementioned new and ambitious prudential tools. Only controlled adjustments aimed at fixing specific components of the framework should be pertinent at this point.

Regarding those apparent differences

We note that one of the major concerns behind the criticism towards risk models is that some of their outcomes look inexplicably different. Nevertheless, evidence found in several studies[1] indicates that only a limited part of the differences require additional investigation and cannot be explained directly. In the same vein, the results of a survey conducted by the EBF[2] with a sample of 43 banks of 14 European countries indicate that the major sources of differences in IRB models for residential mortgages are the characteristics of the market and the legal framework, followed by the differences in methodological criteria.

Objectives are not necessarily opposite

There are opportunities to reduce complexity without removing the benefits of risk sensitive models. The EBF study[2] points out some discrepancies that could be worked out with supervisory convergence and common guidance. We recognise that the EBA is taking significant steps towards consistency and comparability and relevant differences are being ironed out. Moreover, the nascent

[1] For example: European Banking Authority: Interim results of the EBA review of the consistency of risk-weighted assets (February 2013). The study indicates that 50% of all observed variation can be explained by a simple analysis of portfolio mix while only a limited part of the differences is down to conceptual variations in the models.
[2] EBF Study on IRB models for residential mortgages in Europe (July 2012).

Banking Union may apply the common definitions in the balance sheet review preceding the handover of supervisory powers to the Single Supervisory Mechanism (SSM).

Different types of models

Given the different nature, characteristics and degree of trust in models, the analysis of the performance of models could be split in 4 categories:

- Retail and SME models;
- Large corporate and counterparties;
- Sovereign and institutions;
- Trading book.

The nature of the models and their complexity are completely different. So the distribution of risk events, for instance retail and SME models do not involve significant amounts of tail risk. More importantly, the degree of trust varies substantially among types of models.

Summary

In summary, the EBF would expect the BCBS to move forward keeping the value of Basel II, including its risk-sensitiveness and working out the differences in supervisory practices with no hesitation. There is need to back the merits of Basel III in front of banks, analysts, the market at large as well as the media and general public. No room should be given to the possibility of detecting doubt in the current well-rounded prudential framework, including its various checks and balances. With all its elements of risk management, including back testing and performance reviews of models and the enhanced resilience that is being phased in, the regulatory framework is at a high-level of control. It could do with convergence in certain areas and increased coordination among supervisors.

Furthermore, should a future financial crisis surge in a global banking sector governed by a blunt prudential framework based on leverage or standard ratios it would be all the more regretful to have abandoned the current framework of rich and risk sensitive information.

In our opinion, the BCBS should stick to its commitment to provide advanced tools to measure, manage and monitor risks in the financial system, and it should provide continuity.

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SPECIFIC QUESTIONS

QUESTION 1

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

We firstly assess the degree of success of the current framework in meeting each proposed objective and then evaluate to what extent the observed deficits and overachievements could be explained by trade-offs between the various objectives. Finally, we draw a conclusion on the appropriateness of the balance.

Objective 1: Produce a sound minimum standard of capital adequacy for internationally active banks, but also be capable of application to smaller institutions

Largely achieved.

The combination of approaches that the Basel II framework offers to assess the capital adequacy of banks for credit risk, namely the standardised approach, the foundation internal rating based (IRB) approach and the advanced IRB approach, has successfully allowed the use of a unique framework by banks of different sizes and geographical presence.

The experience of the EU proves the helpfulness of the multi-approach setup. The current framework has been implemented in the entire EU banking sector covering more than 6,000 institutions: Large and small, wholesale and retail, local and cross-border credit institutions.

The merit of the current framework is its capacity to bring under the same concept of capital adequacy the entire universe of credit institutions allowing the more advanced entities to develop in-depth analysis, while making more simple methods available to smaller entities in respect for the principle of proportionality. It is also worth noting that the chapter on risk mitigation techniques is available in all approaches hence offering the right incentives to sound risk management and collateralization to all entities no matter the approach chosen.

Objective 2: Deliver a well-understood measure of capital adequacy that is comparable across banks and over time.

Underachieved.

In our opinion, the current framework could improve in the areas of harmonisation and communication in order to achieve a higher degree of understanding. Anyways, the objective of comparability can only be truly achieved through a risk-sensitive modelling approach. We would argue that good understanding should be an overarching objective whereas fair and clear comparability is just one more benefit that would come along with better understanding. Our argument is further elaborated under the heading of question 2.

As regards the specific task of comparing data, our analysis is based on the 2 dimensions put forward by the Committee:

- Comparability between banks: The third pillar of the current framework could not be implemented in full mainly due to the fact that the upsurge of the financial crisis turned the attention and resources of banks and supervisors to previously unplanned priorities. In the meantime, many doubts have been cast over how pillar 3 could serve the current information needs with its original definition.

- Comparability over time: When Basel II was introduced, EU banks started calculating their capital adequacy according to the new standards. Comparisons with the former Basel I criteria were made out of curiosity but it was never the intention to arrive at overall conclusions. As a result of greater precision in terms of risk sensitivity, some asset classes (e.g. equity investments and lower credit quality counterparties) saw their risk weights increase under Basel II whereas others were assigned lower risk weights according to their lower riskiness. Comparisons over time were pointless. But after 5 years running under Basel II, comparisons can fairly be carried out for the risks and capital held by the same bank over time.

Therefore, in our opinion, the major problem is the comparability between banks. The main sources of the problem are, firstly, the existing divergences in supervisory practices as well as bank risk appetite and management tools; secondly, the shortcomings of the current reporting framework which are in part a consequence of the former. There is a wider educational need to explain that some residual variability is justified on theoretical grounds, given the uncertain nature in which the industry operates.

As regards the comparability over time, the nub of the matter is to have stability in the framework. Therefore the current framework provides with comparable data over time so long as it is stable. Today there is already a 5-year data record for the many banks that were compliant with Basel II standards from 2008. During the phase-in period of Basel III, i.e. until 2019, banks will have to explain along with the publication of data the variation due to the gradual incorporation of the new standards notably the deductions from capital.

We would like to draw the attention of the Committee to the conclusions drawn from the EBA interim report[3] on the consistency of risk-weighted assets across the EU. The study indicates that 50% of all observed variation can be explained by a simple analysis of portfolio mix while only a limited part of the differences is down to conceptual variations in the models. As to the rest of the unexplicable variation, the bulk of it should be closed so long as the EU continues making headway

[3] European Banking Authority: Interim results of the EBA review of the consistency of risk-weighted assets (February 2013).

towards a single rulebook including further convergence in supervisory practices. The remainder could be analysed using non-binding benchmarks.

Finally, we would like to draw the attention of the Committee to the fact that the upcoming introduction of Basel III as the global measure of banks' solvency will dispel many of the doubts created by the multiple versions of capital ratios that banks have had to disclose in the transition period from the publication of the Basel III package in December 2009 (and its revised version in December 2010) to its entry into force (in the EU on 1 January 2014). Going forward, the adoption of Basel III as the main criteria of solvency should make its calculation simpler and its understanding easier.

Objective 3: Support a reasonable level playing field between banks.

Improvement possible.

One should start off by acknowledging that a true level playing field is hard to realise, but it should be the ultimate goal. Nevertheless, some frameworks can get closer than others to what is considered to be an even competitive field. In this respect, we think that the current framework is the best way forward to support a reasonable level playing field between banks.

In the realm of prudential supervision the level playing field can be damaged by the characteristics of the market, the design of the prudential framework and the interaction between the both. As total equivalence is not realistic, it is imperative to identify and measure the features of the market and the regulatory framework that have considerable effects and discard those which impact is less significant.

The following are the 3 major sources of potentially significant uneven playing field in the current global framework:

1. The underlying accounting standards.
2. The structure of the credit market.
3. The divergence in bank and supervisory practices.

In the first case, i.e. underlying accounting standards, the current framework needs to be adjusted in order to achieve a true level playing field. The use of IFRS in the EU means that netting rules are more stringent than those of jurisdictions where the IFRS are not being followed, particularly the US. It creates a substantial difference that affects the image of solvency of EU banks *vis-à-vis* their US competitors in most of its expressions: From the leverage ratio to other measures like the average risk weight. Another difference that puts EU banks at a major disadvantage is the full deduction of own software from capital instead of the more reasonable US practice of assigning a 100% risk weight to software given that it is central to banks' quality of service and it has been proved to have value even in liquidation.

In the second case, i.e. the structure of the credit market, the current framework tackles the potential problem of playing field thanks to its enhanced risk sensitivity. The fundamental difference in the structure of the credit market is that almost the entire residential mortgage market of the EU remains in the books of EU banks whereas in other jurisdictions the bulk of mortgages is traditionally transferred to government sponsored entities. Given that the risk of the residential mortgage portfolio is considerably lower than the average of other asset classes, should the risk sensitivity of the current framework be eliminated by the imposition of a too harsh (i.e. binding) leverage ratio, there would arise a serious issue of uneven playing field.

The third source, i.e. divergences in practices, affects mainly the playing field within the EU and follows from the divergent interpretations that banks and supervisors have made when the current framework was implemented. We would argue that the solution consists in narrowing the current scope for national interpretation. Decisive steps have already been taken in this direction by the EBA and the ECB.

Objective 4: Take into account the effects of capital requirements on banks' risk-taking incentives, e.g. when faced with regulatory constraints on their capital (and therefore the size of their balance sheet), to seek higher-risk assets as a means of boosting expected returns.

We believe in the positive effects that the integration of the current regulatory capital framework in risk decision making has permitted if compared with the former Basel I regime. The rapprochement between regulatory capital and business management has helped banks and supervisors to see the banking activity from a more practical standpoint, closer to reality. Certain differences remain as regulatory objectives differ but they can be explained and understood.

As regards the allocation of capital to assets of varying degrees of risk, we observe that the current framework gets to strike the right balance between risk, return and cost of capital. In Basel I and in the standardised version of Basel II, higher-risk assets can have a cost of capital equivalent to lower risk assets. Thanks to the implementation of internal risk models banks can now identify and measure the riskiness of every asset hence they are more able to take risk-based decisions and formulate their objectives in terms of risk appetite.

The original purpose of assigning every asset an amount of capital commensurate to the risk involved has been achieved thanks to the true implementation of the current Basel II regime.

Objective 5: promote improved risk measurement and management within banks.

Largely achieved.

The development of risk models is the foundation of risk measurement hence the recognition of the use of risk models for regulatory capital purposes has placed the right incentive in the prudential framework.

One of the major contributions of Basel II has been the pursuit of risk discrimination in the assessment of borrowers' credit risk profile overcoming the former central bias that many rating systems showed. This was a requirement of Basel II and it was checked thoroughly by supervisors in their examination of risk models prior to their authorisation.

But sound risk management requires more than accurate measurement. And it is precisely in other risk management aspects where the current framework, with its reliance on the risk-based capital at its core, has delivered a lot of added value. Unwarrantedly, there is widespread belief that risk models are down to calculating capital requirements in a way that produces lower outcomes. But advanced internal risk based models have a large impact in the decision and monitoring processes, which are at the core of the business, and involve much more including enhanced controls along the whole process of credit risk, internal validation and developments in information systems, all of which are pulled together by the Basel II framework. As expressed by the BCBS in the original Basel II text[4]:

The term "rating system" comprises all of the methods, processes, controls, and data collection and IT systems that support the assessment of credit risk, the assignment of internal risk ratings, and the quantification of default and loss estimates.

Today we can say that the above objective has been largely achieved in the EU thanks to the commitment shown by their supervisors and the investment made by their banks in developments and knowledge.

Conclusion.

In our opinion, the framework is appropriately balanced. There are though certain hitches that need to be fixed mainly in the domain of bank and supervisory practices. The solution requires further convergence. As long as the framework progresses in terms of convergence understanding will be easier and comparability straighter.

In the context of the EU, the calibration of models is generally adequate according to the risk experience. Evidence suggests that it is in fact conservative as shown in a recent piece of analysis[5] with a sample of 23 banks that use IRB models. It was found that the actual credit losses are roughly half than the aggregated expected losses. In particular, actual credit losses are 57% lower than modelled expected losses for the corporate segment, 50% lower for mortgages and 44% lower for institutions. Therefore, the result of models at large includes a substantial margin of conservatism to cover unexpected losses. This conclusion also proves valid for the majority of the individual banks in the sample. The additional measures introduced by Basel III, notably the

[4] BIS: International Convergence of Capital Measures and Capital Standards (June 2006).
[5] Barclays Equity Research (30 May 2013): "Are Banks any good at forecasting? A new angle on the RWA debate".

enhancement of the quantity and quality of capital, should ensure that unexpected losses will be largely covered.

We would suggest that the Basel Committee conducts back-testing exercises of the current internal risk models before embarking on fundamental changes.

QUESTION 2

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

We would advice the Committee to consider the following objectives:

1. Enhanced understanding
2. Improved supervision
3. Credit supply

Enhanced understanding

Improved understanding should be considered as an objective whatever the final shape of the future capital adequacy framework takes. We believe it is a first order objective that should take priority over simplicity because proper understanding allows for well-informed comparisons and helps overcome the fear of complexity.

Various layers of understanding goals should be defined, for instance:

- Experts who can and have to interpret in-depth information (e.g. supervisors).
- Analysts who need to build a well-informed opinion on the institution (e.g. equity firms or rating agencies).
- General public who demand general information.

Adequate understanding means that every stakeholder gets to know what needs to be known for the role played in the banking business and not much more than that.

Improved supervision

The *De Larosière report*[6], one of the most enlightening pieces of analysis in the aftermath of the crisis, identified regulatory consistency and convergence in supervisory practices as key factors to achieve the objectives of policy repair.

The current work being done in the EU to enhance supervisory comparability and consistency will surely help to tackle a number of the observed differences. The single rulebook in the EU including further convergence on certain supervisory practices across the EU is the current direction of travel and should be given continuity to achieve its objectives.

We would also like to note that the stability of the regulatory framework becomes a necessity: Investors and financial analysts are concerned with frequent changes in the regulatory framework. Regulatory changes are oftentimes perceived as a risk because they create uncertainty. This perception is so strong that indicators have been created to assess the potential impact of regulations.

Credit supply

The regulatory overhaul after the upsurge of the crisis suggested that the overall impact of the new regulation should be carefully taken into account. Many impact studies have been conducted since. There was general understanding that the future benefits of a more stringent regulatory framework would justify and even outstrip the costs of enhanced regulation. As forecasting economic data is quite a hazardous exercise, we think that the policy making community should remain vigilant of the effects that regulation may create on the economy.

In the current economic circumstances credit supply is a fundamental factor of recovery and growth. Nonetheless, we are mindful that subdued demand of credit has become apparent in certain countries, but it is a problem that goes beyond the scope of discussion of the present paper. It should be incorporated to the assessment of the regulatory framework on a permanent basis in order to ensure that credit flows to the real economy with no unnecessary constraint from the regulatory framework. A deeper analysis of the effects of the proposed regulatory framework on different asset classes would be necessary as well (e.g. export credit or SME lending).

[6] European Commission: Report of the High-Level Group on Financial Supervision in the EU (chaired by Jacques de Larosière). February 2009.

QUESTION 3

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

We believe the current capital framework was conceived to strike the right balance between simplicity, comparability and risk sensitivity. Simplicity was permitted in the form of a standardised approach for credit risk. Comparability was intended by way of the third pillar. Risk sensitivity was offered to varying degrees depending on the capacity of every institution.

As any regulatory framework, the practical implementation under different circumstances puts the whole system to the test. Learning from experience, the regulatory framework has delivered substantial benefits mainly in terms of:

- Risk management;
- Extensive useful databases;
- Internal controls in place;
- Closer business integration.

In contrast, comparability has not evolved as well as it was expected at the onset. An orderly approach to the improvement of understanding at different levels would complement the framework and would increase its comparability.

As to simplicity, we think it should be a second order objective. For the same level of risk sensitiveness and comparability, it should be better to keep things simple. But we do not think that a straight trade-off between risk sensitivity and simplicity is a good deal going forward; the models used should be sufficiently risk sensitive, given the varying complexities of banks.

When assessing the simplicity of the system, it should be made clear the objective that we want to achieve: “To get the system be simpler” or “to get the system look simpler”. A system based on leverage may appear simple, but it may turn out to be intricate in a closer look. A system based on standardised or leverage measures could become even more complex for the tangle of floors and caps involved which, in combination with different business models and portfolio mix, will make it virtually impossible to interpret.

QUESTION 4

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

First of all, we would like to reiterate that the current framework is conceptually sound. It would benefit from the introduction of certain complements and, mainly, from more coordination and determination in its implementation as well as a thorough review of its communication and understanding. This being said, we think the ideas that would contribute most to improving the balance of objectives are the following:

1. Limiting national discretion and improving supervisory consistency
2. Improving accessibility of Basel II documents (though more ambitious)

Other listed ideas that could be cautiously considered are:

3. Using additional metrics (as benchmark)
4. Reconsidering the linkage between internal and regulatory models
5. Enhancing disclosure
6. Explicitly recognising simplicity as an objective (without removing risk sensitivity)

The ideas that would not improve the regulatory framework are, in our view, the following:

7. Ensuring the effectiveness of the leverage ratio
8. Utilising added floors and benchmarks to mitigate the consequences of complexity
9. Addressing factors driving complexity in a more fundamental manner

The arguments that support our recommendation follow herewith:

Limiting national discretion and improving supervisory consistency

We agree with the Committee that the use of national discretions allows international standards to be better tailored to reflect local conditions. But monitoring and disclosing the use of discretions would ensure that their use is clear and justifiable. We would recommend that the Basel Committee undertakes a global review of the methodological choices made by all supervisors, before embarking on an overhaul of the current framework.

In this vein, the constitution of the EBA as an EU-wide supervisory authority, which holds powers over the rules that govern the prudential framework in the 28 countries of the EU, is an important move in the direction of consistency. The EBA is determined to achieve true harmonisation in the

domain of internal models where progress has already been made. If the EBA gets to define a more convergent calibration methodology in the EU, the problem caused by current divergences should wane.

Improving accessibility of Basel II documents

We would encourage the Basel Committee to undertake a more fundamental project of enhancing communication and understanding. That would include, of course, improved accessibility to BCBS documentation. But the solution to the core problem of understanding goes beyond the remit of the direct users of BCBS documents.

We would recommend the Committee to foster initiatives to ensure that every user has access to the information that is adequate to his needs. It would have to be targeted at three different categories of stakeholders:

- Experts who can (and have to) interpret in-depth information (e.g. bank employees and supervisors).
- Analysts who need to build a well-informed opinion on the institution (e.g. equity firms, rating agencies and specialised media).
- General public who demand general information.

In summary, we think that the current framework could do with better and targeted access to information.

Using additional metrics

Certain additional metrics could be useful to look at if they are used as benchmarks. But using them as the yardstick of banks' solvency could be totally misleading.

In fact, most of the proposed measures are at the disposal of supervisors and can be (already are) used in the realm of pillar 2.

There should also be a review of policy tools for micro-supervision and for macro-supervision as some of the metrics proposed by the BCBS are *de facto* available under the remit of macro-prudential oversight.

Reconsidering the linkage between internal and regulatory models

According to the Basel Committee Newsletter No. 9 (September 2006), the use test was essentially required to ensure that banks produce accurate measurement of IRB components (instead of minimise capital requirements) and to create incentives to keep them accurate and up-to-date, "whereas the employment of IRB components in internal decision-making creates an automatic

incentive to ensure sufficient quality and adequate robustness of the systems that produce such data".

Large efforts and resources were devoted to adapt strategy and planning processes, and credit exposure measurement and management (credit approval, review and monitoring, reporting, performance assessment, pricing, individual and portfolio limit setting, etc.), so as to minimize the possibilities of arbitrage. Therefore, a linkage between internal and regulatory models should exist.

Enhancing disclosure

EBF member banks have recently been devoting large amounts of resources towards meeting new international and domestic disclosure requirements. While the EBF generally recognises the value of some of these new developments, we are concerned that the ever increasing disclosure requirements are not contributing to transparency as intended, but instead adding to the overall complexity of the regulatory framework.

Initiatives like the Enhanced Disclosure Task Force (EDTF) represent a step forward[7]. The EDTF has set out a framework for the disclosure of a greater quantity and quality of information which will improve market understanding of business models, risks and RWA.

Nevertheless, it is not just a matter of comparing numbers. We think that producing more tabulated disclosures should not necessarily mean an improvement, given that numbers can never on their own provide an accurate assessment of risk. Users should be mindful that two institutions should not be straightly compared by just a handful of figures. There will always be need for explanation, interpretation and judgment.

Technical data like those suggested in paragraph 52 (methodology, assumptions, key model choices or data periods) can only be meaningful for the experts of the competent supervisor. But data of this nature can hardly be interpreted by other less specialised users and its disclosure would surely feed the iniquitous argument of models' complexity. And it would compound the problems of comparability.

Explicitly recognising simplicity as an objective

We would respectfully challenge the idea of setting simplicity itself as a primary objective. We think that risk sensitiveness and comparability, as well as enhanced understanding, should take priority over simplicity.

[7] We note that the EDTF has the support of the CFO Network with the participation of 23 large EU banks.

Ensuring the effectiveness of the leverage ratio

Leverage should not be the binding factor of micro-prudential capital requirements. Leverage should be monitored first and foremost at a macro-prudential level. It is the leverage of the system that could pose a threat to financial stability hence it has to be monitored at sector level.

Harsh leverage ratios favour certain asset classes in detriment of others with no fundamental justification. The wrong incentive of discouraging low risk assets should also be carefully examined.

Leverage would allegedly bring simplicity but so long as it becomes the binding factor of capital requirements it would reduce the meaningfulness of information, the right incentives and tools for effective risk management. In a world of leverage-driven banks analysts would need much more information, and more meaningful, to conduct well-informed assessments. Information that would be more difficult to obtain or simply not available at all in a leverage-driven banking system.

The interplay between the leverage ratio and the liquidity coverage ratio (LCR) creates a perverse effect that penalises low risk portfolios like residential mortgages which are not eligible as liquid for LCR purposes.

If leverage replaces models in practice (as the binding factor) then we can expect that models be maintained in the short time by inertia but be rendered useless gradually as it would not make business sense to maintain them.

Utilising added floors and benchmarks to mitigate the consequences of complexity

It is generally assumed in the discussion paper that caps and floors would reduce risk weight variation across entities. We think the objective should be to reduce only the variation that cannot be explained without "throwing the baby out with the bath water". The total risk weight variation is due to two causes: Firstly, risk discrimination ("fair variability"). Secondly, different practices ("unjustifiable variability"). Unfortunately, caps and floors would only remove the "fair variability" by removing the sharpness of risk discrimination whereas the "unjustifiable variability" will stay as divergence in practices would remain untouched.

The imposition of floors entails a shift of business to segments that are not hit by the floor. There is an artificial process of re-pricing that inevitably leads to increases in the cost of borrowing with asymmetric distribution among asset classes.

Interestingly, the BCBS report on IRB models in the banking book found that counterparties were rightly ranked according to their risk. So it can be concluded that the rating systems perform as expected, i.e. they rank borrowers according to their credit quality. If there is any degree of unacceptable variation in the calculation of risk weights, it has to reside in the calibration of the systems but not in the systems themselves. Therefore, we would recommend that the Committee

reviews the calibration phase but do not curb the field of vision by imposing additional caps and floors.

Addressing factors driving complexity in a more fundamental manner

It does not look consistent to rule risk management with the yardstick of accounting information: Convergence in risk management practices is achievable but convergence in accounting measures has proved extremely difficult after decades of countless intents.

Basel II gave recognition to economic capital models as a complement of regulatory capital models. None of them would have *raison d'être* in a setup ruled by accounting measures and leverage. The wealth of risk information would be discontinued and lost in the not too distant future.

Standardised models are also dissimilar between jurisdictions, in part for choices like mitigation techniques and loan-to-values (LTVs) and in part due to differences in the underlying assets. But the differences in standardised and leverage models cannot be closed up because there is no consensus on the right direction. At least, with risk models, we know where to go.

QUESTION 5

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

We believe in a concept of responsible modeling. Banks perform their business, use models fairly with a satisfactory level of business integration and are duly supervised by well-informed and well-resourced supervisors. The best way to achieve a sounder banking sector is to invest in supervision. Better than rescuing institutions or than ignoring the improvements of risk management that models bring along.