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Banking supervision
And Accounting issues Unit

The Director

Paris, October 11th 2013

French Banking Federation comments on the Basel committee consultation on the regulatory framework: balancing risk sensitivity, simplicity and comparability (BCBS 258)

Dear Sir,

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

FBF appreciates the opportunity to comment on the consultative document on the regulatory framework: balancing risk sensitivity, simplicity and comparability and supports the Committee's objective to design the ideal regulatory framework which strikes the appropriate balance between the complementary goals of achieving risk sensitivity, simplicity, and comparability.

Our position is to defend a regulatory framework which contains metrics having different properties with different and complementary objectives. The risk-based capital regime should remain at the core of the regulatory framework.

Differing results in RWA computation between banks should not lead to the simplistic conclusion that internal models and reported RWA lack integrity.

Most of the alternative proposals are not realistic options and could turn to be counterproductive in the end.

Mr. Wayne BYRES
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on banking and supervision
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You will find in the appendix attached our response to consultation that is organized in 2 sections:

- the first section consists of general comments on the consultation;
- the second one is dedicated to answers to the questions raised in the consultative document.

We thank for your consideration and remain at your disposal for any question or additional information you might have.

Yours sincerely,

Jean-Paul Caudal

French Banking Federation response to the BCBS 258
Discussion paper
The regulatory framework: balancing risk sensitivity, simplicity and comparability

The objective of this discussion is to design an ideal regulatory framework which strikes the appropriate balance between the complementary goals of achieving risk sensitivity, simplicity, and comparability.

Our position is to defend a regulatory framework which contains metrics having different properties with different and complementary objectives. The risk-based capital regime should remain at the core of the regulatory framework.

Differing results in RWA computation between banks should not lead to the simplistic conclusion that internal models and reported RWA lack integrity.

Most of the alternative proposals are not realistic options and could turn to be counterproductive in the end.

Most striking points:

- simplicity is not an objective of regulation as such, it is a second order objective: a sound regulation must be risk-sensitive, comprehensive, consistently applied across jurisdictions and institutions, credible, and stable over time.
- Basel II is risk sensitive and that was the objective sought: Basel I, which was a simple regulation, widely opened the door to regulatory arbitrage; furthermore, the objective of Basel II was to create a risk sensitive framework based on banks risk management tools; in that respect Basel II was fully successful (i.e. less regulatory arbitrage and more risk-sensitive rules).
- The problem of Basel II nowadays is not the accuracy of models. A recent Basel Committee report on the consistency of RWA evidences that the main differences across RWA can be explained by differences in asset composition. Among the remaining differences, the main drivers appear to be the differences in bank risk modeling practices and in supervisory practices (e.g. downturn LGD, length of historical database, etc.).
- At the end of the day, what the BCBS study shows should be rather reassuring: differences in risk parameters (PD, LGD, rating) observed on a benchmark low default portfolio entail variations of -2,2% and +1,8% of RWA, which are rather small; furthermore, the same study shows that all banks covered rank counterparties in the same way in their rating models. These results should provide comfort to regulators and supervisors when considering that 32 banks were covered from very diverse countries like India and the US.
- The problems of Basel II are linked to the credibility and transparency of models (mainly IRB models).
- Credibility must be restored through bank initiatives (much has been done already through the CFO network – technical notes provided to the regulators – and Pillar 3 enhancement to respond to EDTF recommendations) and regulatory and supervisory initiatives (models have been authorized by regulators and validated by supervisors, therefore it is their responsibility too to restore models legitimacy).
- Some initiatives could contribute to enhance credibility and transparency: mainly initiatives to limit national discretion and improve supervisory consistency (this is one of the objectives of the single supervisory mechanism in the EU) and improve transparency (through Pillar 3 further enhancements).

- Other initiatives should be considered very cautiously since some of them may be highly detrimental for banking activities and financial stability (e.g. imposing floors to model-based RWA or imposing a leverage ratio as the main regulatory metric).
- We would like to point out to the Committee that the standard approach can only be used for the purpose of regulatory capital calculations, and not for risk management purpose. Where the standard approach to become mandatory, this would be in conflict with the "use test" principle, introduced by the Basel 2 framework.

Q1. Does the current framework, with its reliance on the risk-based capital at its core, appropriately balance the objectives set out in paragraph 29?

Extract of the discussion paper § 29: "Clearly there are trade-offs to be made in finding the right balance within the regulatory framework, and the framework should regularly be reviewed to assess whether this balance can be improved. Thus, the remainder of this paper discusses ideas that could be pursued to simplify and improve the comparability of bank capital requirements in the light of concerns that, in its current form, the capital adequacy framework may be too complex and that, as a result, comparability is being hindered. These ideas should be assessed against the primary aims of the capital adequacy framework: that is, the capital adequacy framework should:

- *produce a sound minimum standard of capital adequacy for internationally active banks, but also be capable of application to smaller institutions;*
- *deliver a well-understood measure of capital adequacy that is comparable across banks and over time;*
- *support a reasonable level playing field between banks;*
- *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; and*
- *promote improved risk measurement and management within banks."*

The entire current regulatory framework fulfills all these objectives. The Basel III regulation has introduced in addition to the capital adequacy framework, new metrics with the liquidity framework and the leverage ratio. Such metrics are complementary. Banking regulation has become complex as a consequence of the complexity of banks' daily businesses (following diversification and sophistication of their clients' needs).

- **Finalizing the implementation of Basel III is the most important step that needs to be taken to achieve greater international financial stability,** and "*improved risk measurement and management within banks"*:
  - "full, timely and consistent implementation of Basel III" is an important step in improving consistency and comparability of bank regulation globally;
  - Uncoordinated policy decisions at the national level will further diminish the consistency and comparability of global banking regulation, which contradicts the spirit of Basel.

This finalization, and an appropriate use of Basel 3 framework, will also enable banks to achieve the goals set by the regulators, such as (see § 38) : « *better identify banks' risk exposures and their individual risk profiles, strengthen comparability by reflecting a variety of different risk drivers; encourage better risk management by banks; allow banks to manage their businesses more efficiently in terms of the use of scarce capital; drive a better alignment of prices of banking products and services with their associated risks*" : these objectives are not only desirable globally (at the bank level), but should also be targeted within banks at the portfolio / business line level, which will ultimately benefit to the final customer, and to the stability of the financial system as a whole.

- The regulation has evolved, and the supervision too. The implementation of the Banking Union inside the Eurozone is likely to have a major impact on regulation for banks in every country of the area. The ECB shall ensure a coherent and consistent application of the single rule book.

- The Basel framework with the standard approach, the foundation approach and the Internal Risk Based Approach has allowed the use of a unique framework by credit institutions of different sizes, different business models and geographical presence.
  For a framework applicable to large and small banks we emphasize the importance of appropriately calibrating the standardized risk weights and methods.
  They may be a protection against "model risk" and could help constrain the variation in RWA derived from model output, but the standard approach is not a tool solving every issue:
  - For now no real back-testing of standardized Risk Weights (RW) has been realized;
  - If standardized RW are non-risk sensitive then they may incentivize suboptimal behaviour by banks (such as "subprime" finance) and then should not be used as potential floors;
  - Harmonization of modeling principles and of disclosures (in particular of "global Backtesting") is more appropriate to assess and compare banks' risk metrics.

- The efforts towards simplification should not compromise the effectiveness of internal risk models and the strength of overall regulatory framework. The most important lesson from the financial crisis being that it is critical to continue to measure, manage, and monitor risks (credit, liquidity …) in the financial system according to appropriate rules.

- Regarding comparability, recent regulatory RWA benchmarking studies (EBA, BCBS) where internal models were applied to standardized hypothetical portfolios proved useful to illustrate and understand the reasons for variability of risk assessment by each bank. These studies proved both the existence of outliers and of understandable variations, which illustrates that comparability of RWA should not mean absolute convergence. They could be used by regulators to answer the tricky question « what is the appropriate level of capital for corporates, banks, and sovereigns »? For this very important research, further proceedings should be based on public-private working groups in which representative stakeholders from regulatory bodies and the financial industry would define together the next steps and enhancements of these studies, among which: representativeness of the hypothetical portfolios, legitimate ranges of benchmark values for risk metrics (rather than single benchmark values), normalization of disclosures…etc. The first objectives of regulation are to ensure an adequate protection of customers, and the long-term solvency of the industry: before potentially applying short-sighted measures to the levels of RWAs of some specific business-lines (which may result in sub-optimal capital levels or allocations globally), regulation should reach a proper alignment between macroeconomic risks, and capital requirements.

Q2. Are there other objectives that should be considered in reviewing the international capital adequacy framework?

The FBF appreciates the opportunity to propose other objectives that should be taken into account in reviewing the international capital adequacy framework. We suggest the Committee should consider the following objectives:

- **The stability of the regulatory framework must be ensured.**

The stability of the regulatory framework becomes a necessity.

Investors and financial analysts are affected by constant regulatory changes. Regulatory changes are perceived as a risk because they create uncertainty. Today, some investors and analysts track the potential changes in regulation rather than assessing fundamental economic prospects and real economic risks. This is highly detrimental to the sector and the financing of the economy.

Stability of regulatory framework over time will build its credibility and will allow comparability over time.

- **The capital requirements must be based on risk-based models that must be embedded in internal day-to-day risk management.**

Performing the use test must be explicitly considered as an objective that should be taken into account in reviewing the international capital adequacy framework.

- **The regulatory framework does not hinder the financing of the "real economy".**

In the current economic environment, credit supply is a fundamental factor for recovery and growth.
The cost and benefit of new regulations on different asset classes (e.g. export credit, SME lending) should be assessed before any amendment to the existing regulation.

- **The regulatory framework should be consistently applied to funds, credit institutions and insurance companies.**

Breaking the silos which start to appear between the regulation applied to credit institutions, funds and insurance companies is a necessity to avoid further development of the shadow banking activities and regulatory arbitrage.

Q3. 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?

The discussion paper opposes risk-sensitive models to standardized approaches. The debate arises mainly because of the difficulty to compare between outputs from internal models.

One of the underlying questions to this understanding is: Is it acceptable to have different RWA reported by two given banks on portfolios within the same asset class or even on the same client/counterparty?

The plain and simple answer is yes. In order to help explain why, the 23 banks of the "European CFO Network" have undertaken a joint initiative in December 2012 to identify the drivers of model and RWA differences.
The detailed paper outlines the reasons why the RWA variance occurs.

The first category of differences stems from external factors, for example the structural environment in which banks operate and which may be largely beyond their control, including differences between jurisdictions in supervisory frameworks and practices, legal systems and financial accounting regimes. For example:

- Geographical area of application, e.g. Basel rules are not uniformly applied across countries.
- Prudential supervisory frameworks linked to national discretions or practices, e.g. super equivalent add-ons required by national regulators (such as the imposition of parameter floors) and the diversity of supervisors' approach to model approval.
- Legal system of particular jurisdictions, e.g. bankruptcy procedures and the ability to realize and enforce collateral.

The second category of differences stems from internal factors. These relate to a bank's business model and approach to risk management, including notably the nature of internal models, and are typically specific to individual institutions. Internal factors include the following:

- Model inputs, data and methodologies, e.g. banks have unique internal processes and recovery information, drawn from their own client relationships and loss and recovery history –the latter will result in LGD models reflecting this divergence. In addition, banks use a mix of approaches in market risk model development which can result in divergent RWAs.
- Client, product and market mixes, e.g. with respect to residential mortgage loan, wealthy clients will generally exhibit lower debt-to-income ratios, which translate into lower RWAs. As far as market rules are concerned, credit trading activities attract higher risk weights than other trading activities, all things being equal.
- Conservatism add-ons, e.g. to ensure that risk, and hence capital requirements, are not underestimated by models a suitable level of conservatism is introduced.
- Moreover banks have specific intimate knowledge of their customers: the rating of a given borrower need not be the same in two different banks based on the different relationship each bank experiences with the customer.

The risk-sensitive approaches bring intrinsic added-value

The discussion paper fails to recognize that risk-sensitive approaches are fully embedded within a bank risk-management framework.

- The risk-based approaches reflect the risk profiles of the banks.
  - The Basel 2 framework introduced the notion of "use test" which relates to the internal employment by a bank of the borrower and/or facility ratings, retail segmentation and estimates of PD, EAD and LGD (the "Basel 2 parameters").
  - Through the use test, supervisors take additional comfort that Basel 2 parameters play an essential role in how banks measure and manage risk.

    - Moreover, the employment of Basel 2 parameters in internal decision-making creates an automatic incentive to ensure sufficient quality and adequate robustness of the systems that produce such data
- The risk-based approaches avoid the risk of reverting to credit rating agencies, which is in line with Basel expectation that banks avoid an overreliance on external rating agencies.
- Risk-based approaches ensure that regulatory metrics align with the economics of the bank's transactions.
    - There are three main areas where the use of Basel 2 parameters for internal risk management is observable: strategy and planning processes, credit exposure management and reporting.
        - Strategy and planning processes cover all activities related to a bank specifying its objectives; developing its policies and the plans to achieve these objectives; and allocating resources to implement these plans. Basel 2 parameters may be used in assessment and allocation of economic capital; credit risk strategy; and decisions about acquisitions, new business lines/products, capacity and expansions.
        - Credit exposure measurement and management cover all activities related to management and control of the credit risk that a bank takes as a consequence of implementing its strategies. Basel 2 parameters may be used in credit portfolio management; credit approval, review and monitoring; performance assessment/remuneration; pricing; individual/portfolio limit setting; provisioning; and retail segmentation.
        - Reporting refers to the information flow from credit exposure measurement and management to other functions of the organization. Reporting is a necessary component of defining a bank's strategic goals. Basel 2 parameters may be used in credit portfolio reporting; credit portfolio analysis; and other credit risk information.

Limits of the standardized approaches

The standard approach is not a tool solving every issue.

- The approach may be conceptually simple (exposure x weight) however its implementation in multi-activity banks is complex. The standard approach gives the appearance of comparability, but this is entirely delusive.

    - The treatment of collaterals remains complex.
    - Some widespread standard approach notions are left to interpretation, e.g. the notion of "equivalent supervision" is not defined yet applicable in numerous instances.
    - The transposition of the Basel 3 text into national regulation is sometimes difficult to interpret, e.g. the articles of the European CRR dedicated to the risk weights assignment.
    - Many cases are subject to specific and/or exception-based treatment which brings complexity to the implementation.
    - Some regulatory concepts are specific to each bank like the frontier between retail and corporate clients based on the amount of the exposures.

- Standard risk weights have never been revised or back-tested since the beginning of the current financial crisis. As a consequence, some of them over-estimate the actual risk while others under-estimate it. Overreliance on stale risk-weights may delegitimize the use of standard RWA altogether

- It would be potentially detrimental to the financial stability of the whole financial system if banks started using the standardized approach as their main risk management tool. Standardized approach could encourage every bank to behave the same way, thus creating systemic risk and adding to pro-cyclicality issues which the Basel Committee has been trying rectify through the Basel 3 reform. Model diversity is a desirable phenomenon from a prudential point of view and an economical perspective as it generates less pro-cyclicality.

The leverage ratio is not simple

The leverage ratio measures a bank's capital against the accounting definition of its assets. It is conceived as a "back-stop" metric, it tells nothing about the quality of the assets. Yet this means a dollar of very low risk assets backed by collateral is treated exactly in the same way as a dollar lent to a risky borrower on an unsecured basis[1]. Treating risky and safe assets the same way when deciding how much capital banks should hold against them will have predictable consequences. Banks will shed safe assets with low returns (since they will have to put too much capital against them) and focus on riskier products and segments with higher returns.

The leverage ratio can only be a component of the regulatory framework rather than intrinsically defining it.

The leverage ratio, as the standard approach, gives the appearance of comparability, but this also proves illusory due to two main reasons:

- The leverage ratio is not model free.
- The accounting standards differ between jurisdictions –for example, derivatives netting is not applied consistently across advanced economies.

In conclusion, the standard approach and the leverage ratio narrow the differences in regulatory approach between risky and safe assets creating perverse and powerful incentives for banks to run higher risk portfolios.

[1] Peter Sands, « In banking, too much simplicity can be dangerous » Financial Times, August 26, 2013.

Q4. 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?

We think the ideas that would contribute most to improving the balance of objectives are the following:
- Limiting national discretion and improving supervisory consistency
- Enhancing disclosure
- Improving accessibility of Basel II documents

We will explain this in further details below, with detailed remarks on the other potential ideas.

1. Explicitly recognizing simplicity as an additional objective

Simplicity is a desirable feature of any system, but it could not be an objective *per se*. It is not required to know how to pilot a plane to fly aboard.
"Explicitly recognizing simplicity as an additional objective" goes far beyond the capital adequacy universe, and according to us is closer to a political objective, or to a new policy of communication. For instance, the European Central Bank recently updated its communication policy and decided to provide additional guidance to the financial markets: although the ECB communication intends to be as transparent and as simple as possible, the economic assessments, methodologies and debates underlying the monetary policy choices are far from simple. Two levels of communication can easily be conceived on such technical concepts as RWAs: simplicity of objectives and presentation at a strategic level should remain compatible with expert guidance at a more technical level.

Recognizing credibility as a goal seems to be a more appropriate objective for the regulatory framework.

The discussion paper is focused on the complexity of the internal model. Therefore it is important to have a well-informed and constructive debate to remind that the 2008 crisis was not a model crisis. One of the most important lessons of the crisis is that it is crucial to continue to measure, manage and monitor risks in the financial system. By reflecting the irreversible complexity of today's world the models have become complex.

It has to be noticed that *The fundamental review of the trading book* published in May 2012 does not follow at all this objective: it contains a high level of complexity, and results in redundant capital requirements.

2. Enhancing disclosure

We support the initiatives aiming at improving the transparency of the financial system. Enhancing the disclosure about the internal model has to be well structured with precisely defined targets, as per EDTF recommendations
Regarding RWAs, we favor the publication of back-testing results, e.g. model performance. A common educative template should be shared between banks.

The different strands of disclosure (accounting, EDTF, securities, national stress-test disclosure, etc.) should be harmonized to avoid further expansion of the volume of bank disclosure requirements.
Indeed, the desired simplicity of the framework should also be targeted on this operational level, avoiding duplication of work entailed by various reporting streams.

3. Using additional metrics

We support the need to avoid over-dependence on individual metrics, such as indicators of bank resilience. Potential additional measures have to achieve the common objective of integrity and transparency in the calculation by internal model of RWAs.

We remark that the metrics linked to the market will be volatile metrics and consequently not relevant since they would bring additional volatility to the system.

4. Ensuring the effectiveness of the leverage ratio

The intended role of the leverage ratio under Basel III was to act as a backstop to the risk-based ratio. The fundamental concern with the ideas reviewed in the Discussion Paper is that they would expand the role of the leverage ratio at the expense of the risk based measure. For multiple reasons discussed above, 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 crises prone.[i]
For further comments on this ratio, we will revert the reader to previous industry publications on BCBS 251.

5. Utilizing added floors and benchmarks to mitigate the consequences of complexity

Adding new floors will not improve the comparability: in a recent publication the Basel Committee estimated that only 25% of RWA disparities were due to modeling differences between banks.

6. Reconsidering the linkage between internal and regulatory models

Regulatory models are designed to protect the solvency of the institutions in a severe environment (defined as a high quintile of a risk distribution). Internal models, on the other side, are firstly designed to provide managers with guidance in a Business As Usual environment, i.e. at a lower quintile of the risk distribution. Although consistency is expected between the results provided by the two models, a full correlation is not guaranteed, and the institution has to keep room for maneuver in its daily operations.
The standard method can only be used for the purpose of regulatory capital calculation, and not for risk management purpose. If the standard approach becomes mandatory, it will also be a violation of the use test principle.

7. Limiting national discretion and improving supervisory consistency

- In Europe, we support the Banking Union process. The Regulation voted on 12/09/2013 confers key supervisory tasks and powers to the European Central Bank (ECB) over all the credit institutions established within the euro area. The ECB carries out its tasks within a Single Supervisory Mechanism (SSM) composed of the ECB and national competent authorities. The ECB shall ensure the coherent and consistent application of the Single rulebook in the euro area.
- The decreasing number of national discretions will improve the comparability.
- Supervisory consistency would also be ensured by a lower number of bilateral conventions between regulators, and individual institutions.

8. Improving the accessibility of Basel Committee documents

We agree with the Basel Committee about the proposals.

9. Addressing factors driving complexity in a more fundamental manner: (Tangible leverage; Leverage ratio and a standardized approach; Pre-commitment approaches)

The alternatives to the leverage ratio and the standardized approach are not realistic.
The leverage ratio can be only one element within a regulatory framework. The solvency ratio and the leverage ratio have different objectives. One cannot replace the other. The risk-based capital regime should remain at the core of the regulatory framework.
Even Andrew Haldane at the Bank of England, in his Dog and the Frisbee paper, doesn’t call for a leverage ratio on its own.

Q5. Are there other ideas and approaches that the Committee should consider?

Regulators and national supervisors should play a more active role in explaining the accuracy of models implemented by banks. Models have been designed and authorized in recent regulation and regulators should explain in simple terms the rationale and the underlying of models prescribed (e.g. through working papers, technical notes). The regulatory framework would perhaps look less complex if regulators could explain to the public the specificities of regulatory models and their different components.

In the same vein, national supervisors should be more transparent in their methodologies to assess regulatory models used by banks. When national discretions exist in the model validation process, supervisors should set forth clearly the approaches chosen (e.g. length of default data period, estimation of downturn LGDs, etc.).

Furthermore, the present paper deals with the quantitative aspects of the regulatory framework, especially with respect to credit risk. It ignores that risk management is not only a matter of risk quantification but also, and mainly, of internal risk management practices and policies. The complexity of the risk quantification framework does not mean that banks can arbitrage the rules. Banks are bound by internal rules and procedures defined and controlled through an overall risk governance system (e.g. sets of internal limits, selection rules, hedging policies, etc.).

In France, those internal risk management rules are set forth in a specific regulation (Regulation N°97-02 on internal control) and closely monitored by the supervisory authority. The Committee should also take into consideration those simple, but critical, internal risk management rules when dealing with the simplicity and risk sensitivity of the regulatory framework.

In parallel, the Committee should also continue to investigate in differences in the application of the Basel II and Basel III frameworks. Those investigations should lead to the convergence of supervisory practices among countries.

Conclusion:
Not only should model-based approaches be formally retained, but there should also continue to be capital incentive to use these approaches. The internal usability of models should not be compromised.