Saudi Banks Comments on the BCBS Consultative Document regarding Discussion Paper on the Regulatory Framework: Balancing Risk Sensitivity, Simplicity and Comparability

Bank # 1

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?

Bank Response:

In general, the current Framework as enhanced through Basel III, does balance the objectives set out in paragraph 29. We however offer following comments that may require attention:

- Comparability across the banks is difficult for the reasons already identified in the Discussion draft, such as, due to extensive use of internal models where inputs are controlled by the banks, and often are themselves based on statistical estimates etc.

- A sub-set of tiered ratios like CET1, Additional Tier 1, Tier 2, etc. may not reflect the desired results in assessing the quality, volume, and adequacy of a bank's capital. Consequently, these may be translated into a lesser number for simplicity and comprehension purposes.

- Multiple layers of buffers (capital conservation buffer, counter-cyclical buffer, G/D-SIFIs where applicable) reduces the significance of risk assessment and resultant capital charge as a result of Supervisory Review Process (under Pillar 2). These buffers also significantly undermines minimum Pillar 1 capital charge (at 8%). Therefore, these layers may be amalgamated for the aforementioned reasons.

- The systemic impact of G-SIFIs varies considerably than the D-SIFIs. While Basel differentiates the two, the resultant capital charge estimation methodology needs to be specified for both D-SIFIs and G-SIFIs. In this respect, the methodology for D-SIFIs should be simplier Vs. the one for GSIFIs

- Due to complex nature of inputs involved in internal model calculations, which are subject to internal or external validation data validation approaches and application of standards may vary. Thus, output results metric may not be comparable amongst banks.

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

Bank Response:

Perhaps adding simplicity as an explicit objective will help counter the tendency towards more complex framework in pursuit of risk sensitivity.

Generally, the five listed objectives covers the necessary elements for an international capital adequacy framework. This is assuming that application and implementation capacity/ability of smaller banks, with less complex risk portfolios, is also addressed in meeting the objectives of paragraph 29.

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?

Bank Response

From the perspective of Risk Weighted Assets calculations, availability of Standardized Approaches in the current framework, especially for smaller and less complex banks, there is a reasonable balance between simplicity, comparability and risk sensitivity. However, the perceived benefits given the costs of greater risk sensitivity embedded in Advanced Approaches, the current framework has not been effective during the recent financial crisis. Consequently, it failed to strike the desired balance of risk sensitivity. In this respect Basel Committee's initiatives through this Discussion paper and other work in progress, are steps in right direction to ensure that the framework strikes a right balance between simplicity, comparability and risk sensitivity in the context of cost/benefit analysis.

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?

Bank Response

The idea of "addressing factors driving complexity in a more fundamental manner" has the greatest potential benefit considering the longer term objective of this initiative.

Amongst the remaining proposed ideas, following three are presented in order of benefits, keeping in view the framework objectives:

i. Explicitly recognize Simplicity as an additional Objective
ii. Ensuring effectiveness of Leverage Ratio as being a simple additional measure to bring about enhanced risk sensitivity.
iii. Reconsidering the linkage between internal and Regulatory Models

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

Bank Response

To bring in simplicity and comparability and risk sensitivity, the following maybe considered:

- Limiting internal models to core risk estimates and use of stress periods as part of internal data to update the models.

- Major innovation in terms of new products and transaction structures should require prior concurrence from local Regulators.

- Internal Capital Adequacy Process (ICAAP) & Stress Testing output should show banks' position at different levels of shock under stress including any forecast period.

- Basel should consider setting a range (cap and a floor) for P2 risks capital requirement.

- Few of the methodologies for assessing Pillar 2 risks have gained reasonable acceptance across the banks / jurisdictions (like interest rate risk in the banking book, credit concentration risk, settlement risk) which may now be standardized or amalgamated into respective Pillar 1 Risks.

<u>Bank # 2</u>

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?

<u>Bank Response</u>

Bearing in mind that the Committee's Regulatory Consistency Assessment Program (RCAP) provided evidence that variations in applying the framework may be larger than expected, we believe that the Committee's effort needs to be focused on improving the comparability of capital adequacy ratios across banks and over time and to maintain a reasonable level playing field between banks. In this regard, we see that a key factor in achieving this is to review comparability of the current national discretions.

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

<u>Bank Response</u>: No comments.

Q.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?

<u>Bank Response</u>

In our opinion, basing the capital framework on banks' internal models is the right approach in assessing the simplicity, comparability and risk sensitivity in the current capital framework. However, the model approach gets complex due to problem in collecting granular and frequent data. In this respect, the consultative documents "Capital Requirements for Banks' Equity Investments in Funds", "Capital Treatment of Bank Exposures to Central Counterparties", and "Revisions to the Basel Securitization Framework" purported to achieve risk sensitivity are good example, however, these are not simple. Further, the banks are required to obtain granular and frequent data as inputs to the calculation. Also, such data may not be readily available and some are even not disclosed by funds / central counterparties. In this regards, we appreciate offering alternatives methods than those proposed in some of these documents.

Q.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?

Bank Response

We support establishing a standardized framework for assessing policy proposals against improving the balance between the simplicity, comparability and risk sensitivity of the capital adequacy framework. We also support limiting national discretion to improve comparability of risk-weighted assets across jurisdictions.

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

Bank Response

We suggest to asses new proposals against its data requirements. Proposals should be based on internal data generated within the normal accounting or risk management functions. Proposals should avoid as much as possible reliance on data obtained from a party that may introduces a conflict of interest. For example, relying on data provided by a fund manager or a securitization issuer in the calculation of risk-sensitive capital requirement may present opportunities for a compromise on the objectives.

Bank # 3

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?

Bank Response

At least, since the introduction of Basel II almost a decade ago, banks are familiar with managing their businesses within the constraints of a risk-based capital framework.

Broadly, the regulatory framework achieves balance between the objectives set out in paragraph 29. However, following the 2008 financial crisis, it is appropriate to assess the effectiveness of elements of the risk-based framework which may not have been adequate to cater for unexpected market outcomes and losses that crystalized.

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

Bank response

Under Basel II, attempting to align regulatory and internal risk management approaches and drive risk management practices towards sounder and more risk sensitive, and more complex, risk management framework was a more or less an explicit objective. This was achieved particularly through the introduction of a range of Internal Model (IM) approaches which generally resulted in lower capital charges. It is not obvious that banks that adopted these more sophisticated techniques fared better in the crisis than those applying a more common sense approach. Indeed as the paper describes, two or more banks applying their own “risk sensitive” techniques frequently came to very different conclusions about the level of capital required. This is not a failure of risk sensitivity per se – each model may be very sensitive to changes in the level of risk – it is rather a failure of the models to achieve what ought to have been their core purpose: ensuring adequate capital to weather adverse conditions.

Additionally, we believe that a core objective of any review of the capital adequacy framework should be to ensure the effectiveness of the framework in achieving its purported purpose. In our view the core purpose relates to the maintenance of sound banks and a sound international banking system. The laudable aims of sensitivity, comparability and simplicity only make sense to us in this context.

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?

Bank Response

An underlying theme presently seems to be a transitioning from, or at least introducing supplements to, the more complex and expensive approaches that can be adopted under Basel II to a more simple approach. In this transitional state, which presently largely manifests itself with the imposition of additional requirements – some relatively complex – some very simple, the regulatory capital framework is something of a patchwork. We would reiterate the overriding objective of effectiveness in delivering the core objective of regulation must outweigh the secondary objectives listed here.

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?

Bank response

It may be appropriate to set thresholds and disclosure requirements based on the balance sheet size, jurisdiction, composition and primary business activities of the institution to allow a relative comparison with other institutions having similar attributes. This approach also may also help form the level of floors for minimum capital levels.

Given that the capital adequacy ratio is the single most important metric, there should be the minimum amount of combinations to ensure clarity for the users of financial information. In the interests of removing hybrid / non-loss absorbing instruments from capital, additional Basel III classifications of capital were developed but are not easily understood and may result in multiple ratio calculations For example, separate ratios for Common Equity Tier I, Tier I and Tier I plus Tier 2 capital etc. This is an area that may be considered for simplification rather than enhancing with supplementary metrics.

In summary a single leverage ratio and a minimum amount of risk-adjusted capital ratios would assist the proposal for greater simplicity and comparability.

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

Bank Response

We would once more reiterate the importance of looking at the core purpose of regulation and its effectiveness when considering the current capital framework, and any future developments, rather than being tempted to follow risk sensitivity for example, for its own sake.

<u>Bank # 4</u>

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?

<u>Bank Response</u>:

Yes, in the main, we believe it does. However, further efforts need to be made to make it more universally understood. I.e. not just for sophisticated investors and analysts.

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

<u>Bank Response</u>:

Yes. We believe that systemic risk arising from a few significantly important non financial institutions in various jurisdictions would benefit from closer regulatory supervision. The strengthening of the link between SREP and the relevant financial market conduct authority may result in increased awareness and responsiveness to any perceived risk (e.g. market abuse) that could otherwise arise or be prevalent.

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?

<u>Bank Response</u>:

Often, the amount of human and financial resources required seems to be disproportionate to the size and operational nature of smaller banks.

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?

<u>Bank Response</u>

Use of floors to mitigate complexity. However, care should still be taken to ensure sufficient incentive relative to standardized approaches, as banks ultimately remain very commercially oriented.

Use of hypothetical portfolios and comparative disclosure. We feel that this will provide a more tangible and effective comparison across banks, especially if performed and released by the regulator.

Explicitly recognizing simplicity as an objective, but equally, up-skilling of senior management must continue.

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

<u>Bank Response</u>:

Yes. Development of structured training programmes in order that regulatory concepts and rules are clearly, consistently and unambiguously communicated to practitioners.

Bank # 5

Bank Response

The reading of the document suggests that the Committee's intended direction is towards reducing its reliance on internal models for regulatory purposes. The Committee should look into this aspect more carefully, since banks over the years have spent substantial amount on developing models to comply with advanced approaches of Basel-II. Moreover, lesser differentiation in capital benefits between "standardized" and "advanced" approaches, will result in lesser incentives for banks to move to advanced approaches. This will also lead to undesired adverse consequences on the risk management capabilities of the banks, which is a direct result of the adoption of advanced approaches.

Reliance on risk-based Capital

We are of the view that the risk-based capital regime should remain at the core and focus of the regulatory framework. However, the complementary measures issued under Basel II.5/III (like leverage ratio, liquidity measures, quality of capital etc.) will help in better understanding the overall risks inherent in the banks.

Comparability among Banks:

Under the current framework, risk weights/CCFs for various assets classes/products are uniformly applied across geographies. We are of the opinion that risk profile of assets classes/products change significantly across geographies due to many factors such as widely varying bankruptcy laws and product structures. Therefore, degree of risk sensitiveness of current capital adequacy measures may not be comparable across geographies.

Balance between Simplicity & Sensitivity:

The simplicity of operational risk capital measures under SA approaches may be compromising its risk sensitivity. With AMA framework still evolving, the committee may consider alternate interim matrix which is more risk sensitive than standardized approaches of operational risk.

Other Areas

One additional area, where the Committee can further enhance its guidelines is related to "stress testing". The Committee may consider enhancing its guidelines on standardizing the stress testing exercise, across various jurisdictions to enhance comparability among banks.

The last financial crisis has highlighted the flaws in relying on the capital adequacy only and the regulators have very rightly introduced other non-risk-based measures. However, one key aspect that needs to be considered is "cost benefit" analysis of introducing any further regulations/metrics. The financial crisis has indicated that complexity of risk-based capital management has definitely not resulted in improved performance. The banks, perceived to have most advanced risk management techniques/models had to rely on bail-out packages.

Bank # 6

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?

Bank Response
Partially. As also highlighted in the document, the current framework has weaknesses when it comes to ensure comparability across banks (even within a particular jurisdiction).

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

Bank Response: None

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?

Bank Response
The current framework places greater focus on risk sensitivity than on comparability. The revised Basel III Framework has however improved the balance compared to Basel II Framework. Still, the presence of national discretions and the ability of the Banks to influence the risk weighted amounts (using different approached / methodologies for risk quantification) still results in lack of comparability even within a particular jurisdiction.

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?

Bank Response
Supervisors need to reconsider the linkage between internal and regulatory models

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

Bank Response
In order to balance comparability and risk sensitivity, a potential approach could be to, as a first step, standardize the models used for regulatory purposes within a particular national jurisdiction. This will ensure that individual banks will have little discretion to underestimating risk with the aim of reducing risk-weighted assets. Going forward supervisors of each jurisdiction can then make efforts to reconcile their national regulatory models with other jurisdictions. This should also be accompanied by adequate disclosure by the individual supervisors about how their individual assessment varies compared with other jurisdiction.