Balancing Risk Sensitivity, Simplicity and Comparability

SBG Comments

Standard Bank

1. Introduction

The stated objective of the BCBS in the paper 'Balancing Risk Sensitivity, Simplicity and Comparability' released on 8 July 2013 is that a risk-based capital regime should remain at the core of the regulatory framework for banks. The proposals described in the document will however result in a reduction of risk sensitivity in favour of increased simplicity with the key objective of achieving comparability within and across jurisdictions.

There are two levels of proposals – the first set considering aspects such as reducing areas of national discretion, introducing more capital floors, adding new metrics to be used in the framework and reconsidering the linkage between internal and regulatory models. These all represent a fundamental philosophical shift from previous Basel principles. The second set of proposals proposes that a number of fundamentally different approaches to capital adequacy be explored in the longer term. These approaches all represent a complete shift away from risk sensitive capital requirements, for example, using a single form of capital (tangible equity) and a single measure of risk (tangible assets), using only a leverage ratio and a standardised risk-based approaches (abandon the use of the internal models approaches) and banks being required to keep capital above a threshold multiple of their measured income volatility. Whereas we support the willingness to revisit existing principles where these have been found inappropriate and/or where the regulatory focus has changed (e.g. from micro to macro supervision), we believe that the experience and advancement of the regulatory evolution should not be lost in the process.

Standard Bank is concerned that the proposals may result in:

- Destruction of **value created in adopted sophisticated risk management frameworks** and internal models over the past decade.
- Potentially adding to and/or only **shifting the complexity** of the existing capital framework, for example by dissolving/reducing the link between internal and regulatory models.
- Achieving **comparability at the expense of appropriate/suitable banking regulations** reflecting the complexity of the industry.
- Attempting to **adapt banking to an ideal simple set of regulations**, rather than developing appropriate regulations for a banking industry which delivers services shaped by market demand.
- **Reduced recognition of structural economic differences** in various jurisdictions which have served countries well in the past.
- Introducing/adopting yet another approach without providing the opportunity for recent changes to approach (such as the developing focus on consistency) being allowed to be **bedded down**.

One of the most significant risks faced by banks today is the pace of regulatory change. We would therefore propose that the current Basel III implementation be completed and bedded down before enhancement/changes to the framework are considered. As a minimum the pace of change/s should be slowed down.

It is our view that that the current Basel III framework has significant value due to its sophisticated approach to risk sensitivity. It is primarily the lack of consistency of application and not shortcomings of the framework itself, which results in quality and comparability being compromised.

Please refer to our detailed comments on the five BCBS questions in the following section.

2. Standard Bank Group comments on questions posed by the BCBS

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

The current Basel III framework does facilitate and to some extent achieve its original objectives. It is primarily not the framework, but the lack of consistency of application that destroys a lot of value of the framework. Our views on the specific objectives mentioned by BCBS are detailed in the table below.

Objectives	SBG position/comments
Produce a sound minimum standard of capital adequacy for internationally active banks, but also be capable of application to smaller institutions.	The current menu of approaches makes the framework suitable for all types of institutions.
Deliver a well-understood measure of capital adequacy that is comparable across banks and over time.	The current framework provides the metrics that can be used to facilitate comparability – however issues identified through detailed analysis of benchmark exercises on both global and jurisdictional level, as well as through peer reviews, need to be addressed in order to achieve comparability: • the current framework may have to be extended to provide more guidance on specific aspects • the lack of consistency in implementation will have to be addressed • an appropriate way to recognise jurisdictional differences without impacting comparability will have to be defined
Support a reasonable level playing field between banks.	The framework provides guidance that would result in a reasonable level playing field if consistently adopted.
Take into account the effects of capital requirements on banks' risk-taking incentives, eg 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.	The approach and metrics used in the current framework does result in a number of significant unintended consequences. The use of a simple leverage ratio could result in banks focusing on higher risk assets.
Promote improved risk measurement and management within banks.	The development of risk sensitive measures has promoted the move towards sophisticated risk measurement and improved risk management within banks.

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

Other objectives that should be considered would be the following:

- ***Consistency of application***, ie the ability to assess and monitor the quality and consistency of implementation in various jurisdictions. A sufficient level of guidance will

have to be provided in all instances to avoid unnecessary differences in adoption in different jurisdictions. Tools can be provided to the BIS member countries' regulators to support them in achieving this objective.

- ***Alignment of risk management practices and regulatory requirements***, including models and key financial metrics. For example, we don't believe there should be a disconnect between how a bank manages liquidity stress and the LCR, or that there should be a difference between structural mismatches and the NSFR.
- ***Approach to facilitate comparability***, e.g. identify a selection of existing metrics that support comparability of banks for both regulators and market participants.
- ***Governance approach for the BIS to evaluate proposed exemptions by member countries*** for consideration to be included in BIS guidelines. Veto process if not deemed suitable to ensure consistency across member jurisdictions.

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?

Simplicity

Banking is fundamentally complex and as a consequence the industry's regulatory frameworks will be complex. It is unrealistic to expect banking regulations to be simple and therefore we do not believe that simplicity should be a key focus/objective of the Basel capital framework. Complexity should be managed through alternate methods, for example, all BIS members adopting global standards and sharing of regulatory tools which will support regulators within this complex context. Support to banks could be for example, through clear channels for addressing detailed technical questions about interpretation of current requirements or proposed changes.

Comparability

The current framework has significant value due to its sophisticated approach to risk sensitivity. However, due to lack of consistency in application, comparability is being compromised. We propose a number of approaches to improve comparability:

- **Consistency** across regulatory jurisdictions through:
    - Clear guidelines on national discretion. We believe that capital is a universal metric and that national discretion can be addressed in pillar 2. However, liquidity is more jurisdictional and as a consequence would require more local adjustments through areas of national discretion.
    - More guidance for regulators on key aspects, for example the use of the original loan rate as discount factor vs. the risk free rate and prescribed/consistent market risk scalars.
- **Reduced but more prescriptive disclosures** of specific existing metrics that are easily understood by the market. These metrics must be selected based on all banks being able to disclose these regardless of approach adopted and the ability of the market to understand and interpret these.
- Comparability should be attempted **at the correct level** – comparability on a high-level will be difficult due to factors such as portfolio mix and risk profile. In other instances the granularity of the framework may not be sufficient to enable a reasonable comparison with another bank, for example, the current level of the operational risk business lines.
    - For this reason targeted global and jurisdictional comparability exercises may be required. We propose greater use of hypothetical portfolios and permanent test beds on a jurisdictional level which will enable regulators to identify and address inconsistencies.

- The use of regulatory colleges to achieve greater consistency and comparability across jurisdictions should be explored.
- Only jurisdictions on the same regulatory regime (ie Basel I vs II vs III) should be compared against each other.

Risk Sensitivity

We strongly oppose that the current focus on risk sensitivity being reduced – this is key to the sound measurement and management of complex risks within banks. Therefore we propose that the existing risk model frameworks continue to be used for the measurement of the regulatory capital requirement; but that specific (simple) metrics and alternate approaches (such as benchmarking exercises) be identified and used to facilitate comparability.

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?

Ensuring the effectiveness of specific, simple metrics such as the leverage ratio and improving supervisory consistency would provide the greatest potential benefit in terms of improving the balance between the simplicity, comparability and risk sensitivity of the capital adequacy framework.

Proposals	SBG position/comments
Explicitly recognising simplicity as an additional objective	Banking is fundamentally complex and as a consequence the industry's regulatory frameworks will be complex. It is unrealistic to expect banking regulations to be simple and therefore we do not believe that simplicity should be a key focus/objective of the Basel capital framework. Complexity should be managed through alternate methods such as BIS members working more closely together and sharing of regulatory methodologies and tools which will ensure consistency and effective supervision within this complex environment.
Enhancing disclosure	Fewer, more prescriptive disclosure requirements can be adopted, using only simple metrics which enable comparability. Current disclosure should be re-assessed to establish what of the information provided are deemed useful. The level of disclosure should also be revisited. Differences between regulatory and accounting standards and requirements lead to confusion in interpreting disclosures. Each section of disclosure should clearly high-light whether it is based on regulatory or accounting rules and more information on the reconciliation between the two sets of requirements should be of value to the market.
Using additional metrics	We do not support the introduction of additional metrics for banks to measure and monitor as it will only add to complexity.
Ensuring the effectiveness of the leverage ratio	We agree with the sentiment, however are concerned that the newest proposals for the leverage ratio are moving the exposure definition more towards a regulatory definition and as such are introducing complexity to this "simple" tool.
Utilising added floors and benchmarks to mitigate the consequences of complexity	Introducing more floors will not reduce complexity, but dilute the value of a sophisticated risk sensitive approach. Therefore we do not agree with this approach. Additional floors also result in unintended consequences, such as the minimum LGD floor for mortgage loans which disincentivises the use of

Proposals	SBG position/comments
	granular risk grades and of having a low risk mortgage loan portfolio. We believe that there are better approaches for achieving transparency and comparability such as benchmark exercises conducted at both global and jurisdictional level.
Reconsidering the linkage between internal and regulatory models	An attempt to decouple internal risk management models from regulatory models would introduce significant complexity within banks and to the way in which banks are managed and run. Fundamental business models could disintegrate within such an environment. Regulatory requirements and constraints now significantly influence business decisions and therefore management information and regulatory reports should be consistent and reflective of the actual management strategy and priorities of the financial institution.
Limiting national discretion and improving supervisory consistency	We believe that capital is a universal metric and that national discretion could be addressed under pillar 2. This will ensure a consistent and comparable outcome with regards to risk weighted assets and qualifying capital. Similarly, for the leverage ratio, the minimum requirement should be the BIS requirement, ie 3%, and national and bank-specific requirements should then be applied under pillar 2. To make this work, the pillar 1 calibration of formulas and requirements will have to be revisited to take the context of all its member countries into consideration and over-fitting to a specific region should be avoided. However, liquidity is more jurisdictional and as a consequence would require more local adjustments through areas of national discretion. Benchmark exercises and the use of use of hypothetical portfolios and permanent test beds (which are calculated and reported on on a continuous basis) would be useful to improve consistency.
Improving the accessibility of Basel Committee documents	We agree and support this proposal.
Addressing factors driving complexity in a more fundamental manner	The above responses clearly raise concerns about over reliance on simplified approaches such as the concepts of tangible leverage or leverage ratios. We are also not in support of excessive structural reforms and we believe the concept of changing bank structures by 'simplifying' them could produce a host of unintended consequences.

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

It would be useful if technical experts of the industry could engage with technical experts of the policy makers more directly. This would assist in removing ambiguity and improve consistent interpretation of regulatory requirements. Working examples by the BCBS and web-sites where questions can be posed would be other suggestions for consideration. These would also aid in achieving greater consistency and comparability of quantitative studies.