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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
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Dear Sirs

We thank the Basel Committee on Banking Supervision for the opportunity to respond to the discussion paper ***The Regulatory Framework: Balancing Risk Sensitivity, Simplicity and Comparability.***

At the core of the prudential regulatory framework is the concept of risk-weighted assets (RWA), and we agree that this is an appropriate juncture to review this aspect of the framework, as published studies from the Committee, the European Banking Authority and by the Prudential Regulatory Authority support the view that differences in the determination of risk-weighted assets (RWA) appear significant and difficult to reconcile.

RWA as a risk-sensitive measure is hugely important, since it is at the heart of the prudential regulatory framework and a powerful driver of bank behaviour. We believe it is possible to achieve significant improvements in the determination of RWA to deliver simultaneous improvements in risk-sensitivity, comparability and simplicity via:

- Eliminating unwarranted differences in definitions and methodologies, and whether imposed by supervisors or chosen by banks, arbitrary conservative restrictions on models. This will reduce a significant component of current differences.

- Enhanced disclosure, which could include the use of risk-sensitive benchmarks and hypothetical portfolio exercises. This will enable the market and regulators to scrutinise residual differences and discuss them with the banks.

- Improvements to the mathematical approaches (e.g. adopting more appropriate risk curves and pooling of data for low default approaches). This will improve risk-sensitivity.

Alternative suggestions such as the use of standardised approaches and the leverage ratio sacrifice too much risk-sensitivity for the gain in simplicity/comparability. And since they largely achieve comparability by ignoring or smoothing out real underlying differences in riskiness, this is a dangerous illusion. Moreover, by narrowing the difference between risky assets and less risky assets, such tools actually create powerful incentives to make bank balance sheets riskier.

- Floors could play a role, particularly for the very low risk, low data portfolios, but for some asset classes the problem is better dealt with by changing the shape of the risk-weight curve (i.e., a different relationship between expected and unexpected

losses); and where floors are used they should be set using pooled data as far as possible, and not set too high, otherwise they will skew behavior.

- In determining RWA, the objective should be to be objectively risk-sensitive. Other concerns, such as macro-prudential considerations, or concentration issues, should be dealt with through buffers and absolutely not by distorting the RWA, since this undermines each of the three objectives of risk-sensitivity, comparability and simplicity

It is in the light of these key observations that we have responded to the specific questions of discussion paper.

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?**

The prudential regulatory framework has recognised limitations, but where it has improved, it has been when it sought to increase and enhance the coverage of risk measurement. Each such improvement has intended to keep risk-weighting techniques in step with market experience.

These improvements have respected the basic principle that if bank capital ratios are to be a measure of solvency then the denominator, RWA, must be a measure of risk.

2. **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 agree that the three principles of risk-sensitivity, comparability and simplicity are appropriate lenses through which to judge the prudential regulatory framework.

The key challenge in reform is to ensure the principles are correctly prioritised to achieve the primary aims of prudential regulation and to avoid misaligned incentives.

The difficulties in comparability are not solved by 'assuming away' complexity. Rather, we should find ways to enhance comparability and simplicity through disclosure and through the elimination of unwarranted differences in RWA determination but without compromising risk-sensitivity.

3. **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 strongly support the suggestion in Section 5 of the discussion paper of "[*l*]*imiting national discretion and improving supervisory consistency*."

There are many unnecessary reasons for differences in credit risk-weighting, varying from fundamental differences in approach such as ratings philosophy, different interpretations of key terms such as 'downturn', 'long-run', 'default' or 'cure', and superficially innocuous modeling parameters such as discount rates. We specifically note that, for as long ambiguity exists in the appropriate ratings philosophy for probability of default ratings systems (though-the-cycle or point-in-time), comparability will be badly hampered. This ambiguity is unnecessary. To be consistent with the underlying theory, ratings systems unambiguously should be through-the-cycle. There are also multiple unnecessary methodological differences in market risk weighting – for example the technique chosen for modeling Value at Risk (VaR), such as historical simulation, parametric or Monte Carlo, the "look-back" period in VaR and the specific time period used to define Stress VaR.

Exacerbating the lack of comparability caused by unnecessary and incoherent methodological discretion is a variety of inconsistent supervisory practices, for example that of imposing idiosyncratic conservatism within model assumptions.

None of the aforementioned differences are readily apparent to market participants, nor do they necessarily reflect underlying risk, and thereby making comparison of institutions needlessly challenging.

Unfortunately we cannot support several of the other ideas outlined in Section 5 of the discussion paper, which we believe would incorrectly skew the balance between simplicity, comparability and risk-sensitivity.

Simplicity should not be an objective of the same order as risk-sensitivity, but if we can achieve risk-sensitivity then clearly we should search for the simplest approach. If simplicity is overemphasised, we will end up with a system that simply smoothes out and ignores differences and that will give us the illusion of a simple, comparable framework. However, if it is only concealing real and significant differences, this is a dangerous illusion.

Standardised approaches, if widely deployed, could lead to profound changes in bank balance sheets and thereby pose material financial stability risks. Whether or not there is a Use-Test, these approaches narrow the gap between riskier and safer assets and thus create powerful and perverse incentives for banks to run higher-risk portfolios, with safer assets migrating to the non-banking sector. These distortions are particularly marked for portfolios with low risk and correspondingly limited default data. This has a notable practical consequence, as, when appraising the models used by banks to determine RWA, we need to be very thoughtful about the definition of “portfolios”, whether by country or by any other dimension, given the trade-offs between sample size and sample homogeneity. The imposition of an overly narrow portfolio definition on a relatively homogenous pool of assets may artificially induce a standardised approach, with the attendant dangers we have outlined. For the same reason we question standardised approaches,

We urge great caution in extending the leverage ratio, however measured, to the point it becomes the binding constraint on solvency. A binding leverage ratio would at a stroke break the link between risk and capital adequacy. It would also disincentivise sound risk management practices such as collateral taking or clearing derivatives through central counterparties, and could disrupt key prudential tools such as Basel 3 liquidity regulation.

The imposition of floors, either on Internal Rating Based approach parameters or risk-weights, would neither reduce complexity nor aid comparability. While there may be a possible role for floors on very low default data portfolios, they should not be used permanently to rectify perceived weaknesses in the underlying theory of risk-weighting itself, particularly the shape of the regulatory risk-weight curve for certain assets like residential mortgages and financial institutions. Furthermore, we do not support the use of floors for macro-prudential purposes whereby the aim is in fact to cool off lending rather than mitigate a model risk: more direct tools such as LTV caps, debt service ratio minima and maximum asset to deposit ratios would be more effective without introducing distortions in risk weight determinations that undermine comparability.

We fully support some types of enhanced disclosure (see below), although we see little utility in asking banks to publish ratios derived from the volatility of earnings, which are based on public data and already are computed by some market participants.

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

We support the suggestion that there is a key role for enhanced disclosure, as more effective disclosure would certainly improve comparability. We see an important role for hypothetical portfolio exercises (HPEs), but we wish to clarify in what way HPEs can be revealing. Despite the repeated claim to the contrary, RWA for the same portfolio at different banks *should not be equal*. Banks' abilities in managing portfolios differ widely, and so may their appetite to run risks or eliminate them. These differences in risk appetite and management skill will be reflected in banks' internal data and quite rightly should result in different capital requirements. It is for this reason that a bank's internal data must continue to play a crucial role in RWA determination, and it is on this basis that the disclosure of HPE results holds its true power: if we have eliminated arbitrary and unnecessary definitional and methodological differences, then the disclosed differences in RWA are appropriate and informative.

We further suggest that HPE disclosures are usefully complemented by a comparison of banks' risk outcomes to an appropriate risk-sensitive benchmark. Such a benchmark might be based on a standard VaR model, or a generic credit model. The benchmark might be set by using pooled industry data to give an average default rate by generic credit grade and, for the trading book, banks readily can compute, for example, a standard one-day 99% VaR. Disclosure of individual bank performance against these benchmark expectations would become a key means of comparing institutions and would shed light on the implied differences in risk management skill in disclosed differences in HPE RWA. This follows as a bank that computes lower than average RWA for an HPE should be expected to outperform the risk sensitive benchmark (fewer than expected defaults, fewer than expected VaR exceptions), at least over time.

Importantly, this approach would retain and indeed enhance the important incentives for banks to pursue internal approaches for accurate risk measurement and management, critically linking RWA to those internal practices, yet markedly improve comparability. (Only a comparison to a *risk-sensitive* benchmark can potentially reveal differences in risk management skill.)

Conclusion – suggested next steps

In reforming the capital adequacy framework, if RWA is to be used at all it must be as sensitive to risk as can practically be achieved. But to work, then RWA must be credible. Hence there will unavoidably be an element of "complexity" to be addressed. However, we feel that by eliminating unwarranted discretion and by increasing the insightfulness of disclosure, the industry can retain both risk-sensitivity and comparability. In this regard, we would recommend the following way forward:

1. A working group of international standard setters, national and supra-national regulators, and the industry should be set up under the BCBS's existing program on consistency. Building on work already undertaken, this body would jointly identify and catalogue differences in risk weights between institutions and jurisdictions, identifying the source of difference, categorising them into those that reflect differences in risk assessment and management and which therefore should be retained and disclosed, and those that should be eliminated. For those practices that should converge, appropriate regulatory instruments could be used at the national or supra-national level, for example the EBA regulatory technical standards underpinning the implementation of CRD/CRR.

2. The BCBS and the industry should continue to work together to identify ways to enhance Pillar 3 disclosures to clarify warranted differences in risk-weighting. This should be aligned with the recommendations of the Financial Stability Board Enhanced Disclosure

Task Force and would include increased disclosure of key modelling approaches and assumptions.

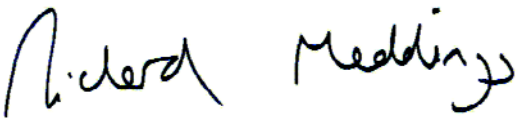
3. When unwarranted differences in risk-weighting have been eliminated, the use of periodic HPEs along with comparisons of risk sensitive benchmarks (based on pooled data) will offer more insight into risk management practices and potentially form a very powerful feature of Pillar 3.

4. Even when unwarranted differences have been eliminated, it is possible that in some cases regulatory bodies will not find certain models acceptable, for example due to paucity of data or disaffection with the embedded assumptions defining the shape of the relationship between model inputs and RWA. In this case, any incremental conservatism ultimately should be applied by altering key assumptions of the underlying Pillar 1 framework, or via Pillar 2 at the firm level in a readily disclosable form. This would avoid undermining the use of RWA models and the unnecessary and counterproductive hypothecation of capital which comes with building buffers or standardised risk-weights into Pillar 1.

We believe that greater convergence in the detail of risk-weighting techniques, that maintains or increases risk-sensitivity and respects the differences arising from different risk management practices and outcomes, bolstered by insightful disclosure, will lead to a framework that is more transparent and comparable while still setting the correct incentives for improved risk management and risk-sensitive capital allocation.

New ideas always raise questions about practicability and of unintended consequences, and these would obviously require further consideration by a broader audience. Should the Committee wish to discuss these matters, we would gladly engage.

Yours faithfully



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