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11 October 2013

By email: baselcommittee@bis.org

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Dear Sirs

Consultation on the Regulatory Framework: Balancing Risk Sensitivity, Simplicity and Comparability

We refer to the consultative document on "The Regulatory Framework: Balancing Risk Sensitivity, Simplicity and Comparability" published by the Basel Committee on Banking Supervision (BCBS) in July 2013.

We agree that this is the right juncture to take stock of the overall objectives of the capital framework, and to consider potential approaches to increase comparability.

We also agree in principle with the primary aims and three new goals. However we would highlight that risk-sensitivity and comparability should be the key focus, with simplicity a supplementary goal to be pursued only where it does not impede the prior objectives.

It should be noted that oversimplification comes at a cost of reliability of the framework (i.e. loss of the risk-sensitivity aspects of the framework). The focus should be on understanding model risk rather than avoiding the use of models.

Our specific comments on the questions in the consultation document are set out in the Appendix. Should you have any questions, please do not hesitate to contact our Assistant Manager, Mr. Timothy Tam, at (852) 2526 6080.

Yours faithfully

Boey Wong
Secretary

cc. Ms. Karen Kemp, Executive Director (Banking Policy), Hong Kong Monetary Authority

Appendix

Consultation on the Regulatory Framework: Balancing Risk Sensitivity, Simplicity and Comparability

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?

We consider that the risk-based capital regime should remain at the core of the regulatory framework for banks and in most respects the current regulatory capital framework achieves an appropriate balance of the main objectives set out in the primary aims.

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

We broadly agree that the primary aims provide comprehensive and appropriate guidance for further development of the capital adequacy framework. That is, as a matter of principle, RWA should be as risk-sensitive as our data and modeling techniques allow.

Nevertheless, we consider that the Committee needs to stress the role of supervisors in setting standards, overseeing risk management, and approving and reviewing regularly banks' risk models, within the context of the rigorous methodological requirements of modern risk management.

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?

We believe that the current capital framework broadly weights the goals of risk-sensitivity, comparability and simplicity correctly. However, there are areas as listed below that the Committee could work further on improving the balance between simplicity, comparability and risk sensitivity.

Recognition of diversification
The current framework does not recognise an institution's diversification across geographies or asset classes, which is a key element of its overall risk profile. This reduces the accuracy of the assessment of capital adequacy and the comparison of risk between institutions, and removes incentives for sound risk management.

National discretions and inconsistent supervisory practices
The application of national discretions and inconsistent supervisory practices has impeded the development of a level playing field. Comparability could be improved via harmonization of national discretions and inconsistent supervisory

practices, where these do not reflect genuine differences in risk characteristics. Similarly, the harmonization of modeling approaches among firms seems essential, where such harmonisation does not eliminate the relevance of internal risk management expertise as evidenced by internal data.

BCBS consultation on the Non-Internal Model Method (NIMM)
In a recent consultation, the BCBS proposed to have NIMM to replace the Current Exposure Method (CEM) and Standardized Method (SM) which strives to improve the risk-sensitivity. The industry stressed in the consultation that the desired risk-sensitivity is not fully incorporated in the method whereas the method may introduce complexity to the capital framework which is not desirable for small and medium sized banks.

BCBS consultation on the capital treatment of bank exposures to central counterparties
In another consultation, the proposed capital treatment of qualifying central counterparties (QCCP) makes use of the minimum level of default fund coverage required under the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO) Principles for Financial Market Infrastructures (PFMIs). One of the industry's concerns is that use of a non-risk based measure could deplete the risk-sensitivity of the capital framework.

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?

In regard to suggestions to improve simplicity and comparability, we have the following comments:

(a) Explicitly recognizing simplicity as an additional objective (paragraphs 48 to 49 of the Discussion Paper)

It is important to emphasize that simplicity as a goal should not be pursued at the expense of the risk-sensitivity objective. Simplicity should not form an explicit criterion for reviewing proposed prudential regulation, and should be clearly defined as subsidiary to the goals of risk-sensitivity and comparability.

Risk-sensitivity aligns the underlying economics of the transaction with the regulatory requirement. It allows banks to properly allocate appropriate capital resources with reference to the riskiness of the transactions. To do otherwise could detract from the primary aim of the regulatory framework - to determine sound and adequate levels of capitalization, and might invite arbitrage.

(b) *Enhancing disclosure (paragraphs 50 to 53 of the Discussion Paper)*

We believe that "enhancing" disclosure should not result in further expansion of the volume of bank disclosure requirements, which would not be helpful to investors and readers of the financial statements/disclosures. Instead, disclosure should be more structured and targeted, and the different strands of disclosure (accounting, Enhanced Disclosure Task Force (EDTF), securities requirements, national stress-test disclosure requirements, etc.) should be harmonized, and duplicative or similar disclosure for similar items avoided.

In addition, disclosing data typically collected by supervisors (e.g. model performance) could potentially raise confidentiality issues.

We also urge caution on the premature introduction of hypothetical portfolio disclosures, for two reasons.

First, it is incumbent on the regulatory community and the industry to eliminate unnecessary methodological and definitional differences in RWA determination.

Second, once this is done, there should still be differences in RWA for the same set of assets (despite the repeated claim otherwise) – as these emerge from different risk management expertise and approaches (which applies equally to trading and banking books).

(c) *Using additional metrics (paragraphs 54 to 56 of the Discussion Paper)*

We support the need to avoid over-dependence on individual metrics (including the leverage ratio) as indicators of bank resilience. Supervisors and investors currently do not just look at one metric to judge the financial soundness of a bank.

The discussion paper proposes that there should be a standardized suite of resilience measures with standardized definitions and a disclosure template. As discussed in point (b), such disclosures should not result in an expansion of disclosures. Moreover, the Committee should avoid requiring disclosure of similar metrics with different definitions that are reported to different regulators. This will only lead to undue reporting burden on banks as well as confusion to the readers.

(d) *Ensuring the effectiveness of the leverage ratio (paragraphs 57 to 59 of the Discussion Paper)*

We have concerns about the proposals of introducing buffers to the leverage ratio and/or setting a higher leverage ratio requirement for G-SIBs. This would effectively make the leverage ratio a binding constraint on capital adequacy. We believe that the leverage ratio should be a back-stop capital measure and should not supersede the risk-based measure as the primary driver of capital requirements.

While the leverage ratio is a simple and transparent measure, it masks the underlying complexity in the banking industry. The leverage ratio alone could not provide an insight on different risk profiles of banks. But it may create incentive to increase high risk assets for higher return and avoid low risk assets with lower return that affect leverage ratio to the same extent.

In addition to its lack of risk sensitivity, the leverage ratio is influenced by relevant accounting rules and discretion of regulators. On top of differences in the treatment of netting, hedging, classification and measurement of financial instruments, the scope of consolidation used for leverage ratio is different from that used for accounting consolidation. Therefore, to ensure a level playing field it would potentially require different calibrations with respect to the accounting and reporting standards each bank has to follow, reducing its purported simplicity.

(e) Utilizing added floors and benchmarks to mitigate consequences of complexity (paragraphs 60 to 64 of the Discussion Paper)

While floors of any type, either at the level of risk parameters or risk weights, marginally increase simplicity they reduce risk sensitivity, and so would not achieve the proposed primary aims, and would disincentivize banks to develop internal models and invite arbitrage.

As mentioned in Q1, the risk-based capital regime should remain at the core of the regulatory framework for banks. We should avoid using floors as hard limits.

(f) Reconsidering the linkage between internal and regulatory models (paragraphs 65 to 66 of the Discussion Paper)

We believe that the linkage between internal and regulatory models is very important. These two models interact and affect each other. We should be aware that regulatory capital models influence heavily on the business decisions within banks. Regulations that diverge far from internal risk practices may lead to wrong incentives. The actual regulatory capital cost is a key driver for pricing decisions as compared to the economic capital.

We also believe that the use test should remain a key element of the regulatory framework, correctly aligning internal risk management with regulatory capital and avoiding incentives for regulatory arbitrage.

(g) Limiting national discretion and improving supervisory consistency (paragraphs 67 to 69 of the Discussion Paper)

Any initiative that allows for a more congruent and consistent implementation of the Basel standards is welcome. On this note, the limitation of national discretion and the improvement of supervisory consistency should not be limited to the principles and approaches, but should also cover the implementation timelines for major markets and the corresponding capitalization levels and expectations.

In addition, the Discussion Paper proposes that a database of national discretions could be developed and published as an aid to comparison. This database would be very useful. But we should always bear in mind the related cost and benefit of having this database and strike the right balance between simplicity and comparability.

(h) Improving the accessibility of Basel Committee documents (paragraph 70 of the Discussion Paper)

We support the Committee's idea to initiate a process to consolidate all the standards into a single, accessible, structured set of documents. This will make the standards easier to find, navigate and understand.

(i) Addressing factors driving complexity in a more fundamental manner (paragraphs 71 to 77 of the Discussion Paper)

The Discussion Paper outlines a number of fundamentally different approaches to capital adequacy that could be explored in the long term. These include (1) tangible equity (using only tangible equity as a measure of capital and tangible assets as a measure of risk); (2) a leverage ratio and a standardized approach (disallowing the use of internal models altogether for regulatory purposes); and (3) pre-commitment approaches (banks could be required to commit to keep capital above a threshold multiple of their measured income volatility).

Each of them would require considerable investigation and debate. The move to a risk sensitive RWA framework under Basel 2 is a development we should reverse with extreme caution: a RWA framework must be seen not only in the light of its comparability and risk sensitivity, but in the light of the incentives it creates. In this regard, we should exhaust those possibilities that exist to retain a risk sensitive RWA framework while eliminating the unnecessary or unwarranted differences in RWA determination.

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

In addition to the suggestions made above we propose that before the RWA framework is rendered more standardized, modeling methodologies between institutions should be harmonized, so that risk measurement for the same portfolio depends only on different risk characteristics and/or risk management practices clearly evidenced by data. Such harmonization must include the clear definitions of important concepts of "portfolio", of "downturn" and "stress period" and of ratings philosophy.

Furthermore, we suggest the Committee reconsiders the specific interpretation of "**comparability between banks**" as stated in paragraph 13 of the Discussion Paper.

In theory, it could be the case that "two banks with portfolios having identical risk profiles apply the framework's rules and arrive at the same amount of risk-weighted assets".

In reality, individual banks will have differences in business experiences, proprietary expertise and operational environment in different jurisdictions, etc. Notwithstanding applying the same framework's rules, individual banks could have different potential and realized losses from identical portfolios. From this perspective, it should be acceptable for individual banks to arrive at reasonable differences in the amount of risk-weighted assets for identical portfolios.

As such, we would support appropriately refining standards and measures applied to validate the risk quantification results and encouraging banks to refine the use test in order to guard against gaming the risk-weighting system while preserving the utility of risk management models.