The Systemic Risk Council

October 15, 2013

Secretariat of the Basel Committee on Banking Supervision,
Bank for International Settlements, CH-4002
Basel, Switzerland.

Re: Discussion Paper on the Balance Between Risk Sensitivity, Simplicity and Comparability within the Basel Capital Standards.

Dear Secretariat:

We[1] are writing to strongly support the Committee's efforts to simplify the Basel capital standards. We believe those standards have become far too complex and are undermining the ability of regulators, policymakers and market participants to assess the capital positions of large, complex financial institutions (LCFIs). We encourage the Committee to simplify the standards by:

- Eliminating the use of internal models to set regulatory capital and replacing them with a much simpler, standardized risk-based capital framework;

- Substantially strengthening the simpler leverage requirement and using it alongside a standardized risk-based framework; and

- Improving transparency and public disclosure so that investors and other market participants can bring market pricing to bear on LCFIs.

Eliminating Internal Models for Regulatory Capital

As we have noted previously, while we commend regulators for moving forward with important rules that raise the overall level of capital required for LCFIs, we have strong concerns about regulators' continued willingness to allow these giant institutions to use their own internal risk models to lower their minimum required regulatory capital. Not only do models routinely fail in a crisis (precisely when we need loss absorbing shareholder equity most) – their use for regulatory capital purposes is a key contributor to complexity and market uncertainty.

By relying on firms' internal models, regulators have made cross-firm comparisons and risk assessments much more difficult, if not impossible. Because different firms model their risks and

[1] The independent, non-partisan Systemic Risk Council (www.systemicriskcouncil.org) was formed by CFA Institute and the Pew Charitable Trusts to monitor and encourage regulatory reform of U.S. capital markets focused on systemic risk. The statements, documents and recommendations of the private sector, volunteer Council do not necessarily represent the views of the supporting organizations. The Council works collaboratively to seek agreement on all recommendations. This letter fairly reflects the consensus views of the Council, but does not bind individual members.

hedges differently, even firms with identical exposures can report significantly different risk-based capital ratios. This undermines market pricing in a number of ways.

A prudent, well-managed firm will appear *less well-capitalized* than an irresponsible, risky firm because the prudent firm's internal models would be more cognizant of risks and threats while the riskier firm might assume a more positive outcome or might miss certain risks altogether. This makes the riskier firm appear safer than the prudent firm misleading investors, policymakers and management who rely on these assessments.

Moreover, even if investors or counterparties discount or ignore these models, they have been left with few other options for effectively differentiating firms on a risk/reward basis because of a dearth of commonly used alternatives and the poor quality of LCFI public disclosures. By muddying these distinctions, efficient investment decisions are undermined: riskier (and especially *larger,* riskier) firms are subsidized and safer firms are penalized for their prudent decisions. This encourages size and risk taking among LCFIs and fosters moral hazard among investors and counterparties.

The use of internal models for regulatory capital also fosters a host of bad incentives. Even well-managed firms may choose to change their model, rather than change their positions, should the positions negatively impact their capital position. Even prudent firms may decide that they are "forced" to change their models to more fairly compete with riskier competitors who use less-prudent models and accordingly are less constrained by capital requirements. This "race to the bottom" further undermines the models' usefulness.

The lack of confidence in models and risk weighting was evident during the financial crisis when the market turned to the simpler (and comparable) leverage ratio instead. Accordingly, we believe regulators should stop using internal models to risk weight assets for regulatory capital purposes. Instead regulators should use a simple leverage ratio combined with a standardized system of risk weights.[2]

Minimum risk-based capital requirements should be just that: a minimum. If internal models identify additional risks that require higher capital, firms should be required to raise more equity. Management, boards, examiners, investors and counterparties deserve an objective and clear minimum risk-based capital baseline.

Strengthening the Simpler Leverage Ratio

While the leverage ratio is superior in a number of respects – a leverage ratio should not completely replace risk weighting. Standardized, regulator-driven, risk weighting is essential for prudent risk management. Relying on the leverage ratio alone could create incentives for banks to take on higher yielding (and therefore, higher risk assets) to maximize return on equity. To counter these incentives, the two approaches should be used in tandem.

For example, by itself a leverage ratio can also mislead investors and markets (by treating all assets the same, regardless of risks) and can also create incentives for firms to allocate resources

[2] The "Leverage Ratio and a Standardized Approach" set forth in paragraph 75 of the Discussion Paper.

to higher yielding/higher risk assets. The best approach is to use a leverage ratio that is complemented with a standardized system of risk weighting. Instead of internal models, the risk weights should be determined by regulators, not the banks, and based on sound judgment as well as strong analytics. The establishment of these weights should be insulated from political interference or desires of governments to drive lending and investments to particular asset classes, e.g., housing or sovereign debt. The process of setting risk weights should also remain fluid, with a basic international framework recognizing the ability of domestic regulators to *strengthen* risk weights (i.e., raise capital requirements) as judgment and empirical experience warrant.

Preserving the use of banks' own models to risk weight assets, while adding yet more limits and constraints as an overlay (as parts of the Discussion Paper suggest) will only add to the complexity created by the models. Years of tinkering with the "advanced approaches" has worsened this problem and confused the market. Instead, these models should simply be scrapped as a tool for setting regulatory capital. However, if the Basel Committee decides to retain the advanced approaches, it is essential that it also retain, as a floor, the simpler, standardized capital rules generally applicable to smaller banks. This is the approach of the "Collins Amendment" in the United States, as well as the approach being followed in Europe which is using Basel 1 as a floor.

Simplifying the Definition of Capital

As part of its simplification initiatives, we encourage the committee to adopt a single, consistent definition of capital. Currently, there are at least four definitions of "capital" used by bank regulators: "Tier 1 Common," (as defined by the Basel III accord); "Tier 1," "total capital," and "tangible equity," with each category being progressively more permissive. A banks' reported capital ratio using the Basel III definition of Tier 1 Common can be dramatically different from its ratio when other definitions of capital are included in the numerator. During the crisis, the market looked to common equity to determine a financial institution's capital strength, discounting the importance of other regulatory definitions of capital. Therefore, we recommend that the Basel Committee use Tier 1 common as defined by the Basel III Accord, and scrap other ratios based on more permissive definitions of "capital" which can be misleading to investors, analysts, and the public at large. The market showed little confidence in these other definitions. Regulators should not have confidence in them either.

In good times, market participants need to be able to compare firms (using meaningful, consistent data) so they can make informed risk-reward decisions. In bad times, all parties need to be able to gauge a banks' real, effective loss absorbency. This approach accomplishes both.

Improving Transparency and Public Disclosure

The Committee's release requests comment on whether improved disclosures can address market confusion over the relative strength of banks' regulatory capital ratios. Disclosure remains an extremely important tool in promoting market discipline. Certainly, more market disclosure about how banks' use models for their own purposes in managing risk would be extremely valuable. Disclosure about how banks' models compare when applied to a hypothetical portfolio,

as well as how they have performed over time in predicting risk, would be valuable market information as well. However, improved disclosure cannot compensate for the inherent flaws in using internal models to set regulatory requirements. Again, we strongly encourage the Basel Committee to scrap internal models in setting regulatory capital.

Respectfully submitted,

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