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Date

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Subject

Response to the BCBS Consultative Document: "Reducing variation in credit risk-weighted assets - constraints on the use of internal model approaches"

Dear Sir/Madam,

ABN AMRO Bank welcomes the opportunity to provide feedback to your Consultative Document (CD): "Reducing variation in credit risk-weighted assets - constraints on the use of internal model approaches". We note that ABN AMRO Bank has participated in drafting the Dutch Banking Association's response to the CD. We fully endorse the response of the Dutch Banking Association (NVB) and present our own response below.

General Comments

We firmly believe in the merits of the Internal Ratings Based approach ("IRB") for the purpose of determining regulatory capital requirements and its use for internal capital allocation, risk management and pricing. We have made a significant investment in capacity and knowledge to build up expertise with internal risk models, which also has created a common perception of risks. These models are anchored in our risk management culture and policies, and form an integral part of our internal rating system, that comprises the processes and controls, and data collection and IT systems that support the assessment of credit risk, the assignment of internal risk ratings, and the quantification of default and loss estimates.

We also note the enhancements to the overall capital adequacy framework introduced by Basel III, complementing it with robust liquidity risk and leverage requirements, strengthening it with further requirements on the level and quality capital, including substantial capital buffers. Besides this, further fundamental revisions to the risk based framework have been proposed by the BCBS.

We strive to further strengthen our internal models and understand the need to improve comparability and address excessive variability in the capital requirements for credit risk. However,

by negating Foundation and/or Advanced IRB for all asset classes¹ or dismissing it upfront for certain asset classes on which sufficient data is available and for which robust and tested internal models are in place, the risk sensitivity of regulatory capital requirements is unduly decreased.

As being a key factor in tactical and strategic decision making and evaluation, less risk sensitive regulatory capital requirements will lead to economically suboptimal business decisions, risk decisions and corresponding capital allocation. Due to the design of the proposed regulatory constraints, most typically this will negatively affect the lower risk sectors or counterparties, and favour the higher risk sectors or counterparties. In the real economy this may lead to intransparent cross-subsidisation between lower and higher risk segments and may even drive banks towards riskier segments to be able to recover the costs of capital involved, which in turn may increase systemic risk.

Overall, we believe that there are several fundamental reasons for variation in risk weighted assets, which can stem from differences in modelling choices, data inputs and interpretation of definitions, use of jurisdictional options and discretions, supervisory guidance across jurisdictions, and differences in business strategy and risk management practices. Therefore, in our opinion the BCBS should address the root causes of the excessive risk weight variation by providing more guidance on definitions such as recognition of default, length of LGD recovery periods, LGD discount rates, and required conservatism for sources of uncertainty. In addition, the BCBS should further stimulate harmonisation of supervisory practices and take into account the insights provided by benchmarking and stress testing exercises performed by supervisors and banks themselves.

Before making fundamental decisions that negate or dismiss the use of IRB for certain asset classes, we call on the BCBS to carefully evaluate all of the recently introduced and proposed regulatory changes holistically, and to ensure that its objective of not significantly increasing overall capital requirements is met.

Available approaches for Banks, Financial Institutions and Corporates

As explained above, we are of the opinion that dismissing IRB upfront for certain asset classes on which sufficient data is available, is too crude a measure to improve comparability and address excessive variability in the capital requirements for credit risk. We therefore urge BCBS to allow the use of IRB models for calculating capital requirements based on clear minimum modelling requirements - including the number of annual (possibly pooled) observations, the quality of data and the performance of the model – and clear guidance on these minimum requirements and modelling definitions to be used for the relevant factors and parameters.

We note that remaining concerns with respect to the reliability of model estimates can, as provided for in the current framework, be addressed by requiring increased margins of conservatism, preferably based on clear statistical norms. In addition, supervisors can use the existing pillar 2 measures to address potential underestimation of capital requirements from approved internal models as part of its model risk assessment.

¹ Through the use of output floors as proposed in December 2014 by BCBS in its Consultative Document ‘Capital floors: the design of a framework based on standardised approaches’

When BCBS still deems it appropriate to limit the extent of use of IRB, we strongly encourage that the valuable information produced by IRB models is continued to be used for calculating capital requirements to the largest extent possible. For example, the internal ranking capabilities (as part of the current internal ratings systems of banks) tend to result in rather consistent² relative risk scores of obligors. This ranking holds valuable risk-sensitive information, information that is not included within the Standardised Approach, especially when obligors are not externally rated, and may be used in any risk weight methodology solution that the BCBS might propose.

Available approaches used for Specialised Lending

Also for Specialised Lending exposures we repeat our statement that we urge BCBS to allow the use of IRB models for calculating capital requirements based on clear minimum requirements instead of dismissing these upfront. Especially given the structured nature of Specialised Lending, which is mainly focused on credit risk reduction using a tailor made and highly collateralised approach, it is not appropriate to impose standardised calculation approaches, when dedicated and robust internal models are available.

In our view, the decision to grant permission to use IRB should be based on clear and transparent set of rules, focusing on sufficient ability to make robust models. Therefore, data quantity and quality as well as other minimum requirements should be the basis for such a decision. Given the dedicated risk management and monitoring processes sophisticated Specialised Lending banks have successfully deployed, we suggest that these minimum requirements should comprise criteria on these discerning aspects as well.

Should BCBS nevertheless still deem it appropriate to limit the extent of use of IRB, we consider the IRB Supervisory Slotting Approach (“Slotting Approach”) as a viable fall-back approach for analysing Specialised Lending exposures. However, we note that the current Slotting Approach needs further enhancements so to fully take into account several very relevant sector and/or business related characteristics and developments, and specific knowledge on the client or products concerned. In this context, we suggest that an additional tenor bucket of shorter than 1 year is introduced, and that more granularity in categories is used, coupled with further guidance on the slotting into these categories. Furthermore we deem it more appropriate to apply the Slotting Approach on a facility level rather than deal level, and that current risk weights are recalibrated to better reflect the inherent risks and ranking compared to non-Specialised Lending exposures.

Finally, as proposed in the current CD, the Specialised Lending category plays a more prominent role in calculating capital requirements and implies a huge capital increasing impact resulting from Specialised Lending exposures vis-à-vis normal Corporate exposures. Therefore, it becomes important to ensure a more clear and objective demarcation between these two exposure classes.

² See also the study performed in 2013 by the BCBS in the context of the Regulatory Consistency Assessment Programme (RCAP) that found a high degree of consistency in banks’ assessment of the relative riskiness of obligors: “RCAP Analysis of risk-weighted assets for credit risk in the banking book, July 2013”)

Approach used for Smaller Corporates and Retail

The risk profile of Smaller Corporates and especially retail and SME clients substantially differs per country and/or region. Setting uniform input floors (or output floors for that matter) globally will have a punitive effect biased towards banks located in countries with less risky portfolios, as banks in countries with riskier portfolios may not be affected at all. Therefore, introducing uniform input floors globally is in our opinion too crude a measure for reducing RWA variability.

We are of the view that IRB input floors (in general) will not address unintended risk weight variation properly. Nevertheless, it could serve as an additional measure to address potential underestimation of risks, if the input floors are calibrated based on the data availability and the performance of the internal models. In case BCBS still deems it appropriate to introduce input floors, these should only have effect on outlier values for PD, LGD or EAD and should only be activated if model performance is below the minimum requirements. Input floors should not be punitive to highly (possibly over-)collateralised, low risk transactions and should not be put on a disadvantage compared to other riskier transactions.

We suggest including the performance of the model in the calibration process of the input floors. For PD models, the performance of the models should be assessed by comparing the predicted PDs to the observed default frequencies. For LGD models, the predicted LGD values should be compared to the actual losses. If the performance is sound (no underestimation of risks) the input floors should not be activated to the model. When evidence shows that the accuracy of a model is below a certain level, it should be the call of the Banking Supervisors to activate input floors, preferably based on objective criteria set by the BCBS. We also note that in the current IRB framework the risk of over-optimism is also mitigated by applying margins of conservatism to model estimates in relation to the expected range of estimation errors.

Off balance sheet commitments

The definition that the BCBS has proposed for commitments raises our concern as the definition can be interpreted too broad. Even arrangements that from a legal perspective do not constitute a commitment to extend credit whatsoever would be considered committed. Instead we propose that the definition takes into account the legal definition of a commitment. It should acknowledge that arrangements are uncommitted when a lender is at all times entitled in its sole discretion to accept or refuse to make any advances to the borrower under such arrangements, even if all conditions to make loans or other utilisations have been satisfied.

Implementation

We also highlight that there would be a considerable amount of system, process, and methodology changes required to implement the proposed changes. In particular, this would involve changes to credit risk management practices and processes with respect to specific requirements on due diligence, assessment of exposures under different approaches and changes in rating systems, and model modifications given the proposed constraints on IRB. Given the inter-linkages and evolving requirements, we will need to be provided with sufficient lead time to fully implement the final changes. We suggest that it could take as many as three years to implement the changes in the CD.

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We thank you for taking our comments into consideration, and we are happy to further contribute to the discussions on the regulatory reform programme that the BCBS has committed to.

With kind regards,
ABN AMRO Bank N.V.



Kees van Dijkhuizen
Chief Financial Officer