



AUSTRALIAN BANKERS'
ASSOCIATION INC.

Aidan O'Shaughnessy
Policy Director, Industry Policy

AUSTRALIAN BANKERS' ASSOCIATION INC.
Level 3, 56 Pitt Street, Sydney NSW 2000
p. +61 (0)2 8298 0408 f. +61 (0)2 8298 0402

www.bankers.asn.au

27 March 2015

Bank for International Settlements
Centralbahnplatz 2
4051 Basel
Switzerland

Dear Sir/Madam,

Basel Committee on Banking Supervision: Consultative Document: Standards: *Capital floors: the design of a framework based on standardised approaches*

The Australian Bankers' Association (ABA) appreciates the opportunity to comment on the Basel Committee on Banking Supervision (Committee) Consultative Document: *Capital Floors: the design of a framework based on standardised approaches* (CD). The ABA is the industry association representing its member banks that consist of domestic systemically-important banks, other Australian "internationally-active banks" and other domestic and foreign banks which are active in the Australian market.

The ABA is supportive of the Committee's work programme to reduce model variability arising from internally-modelled approaches, therefore enhancing the reliability and comparability of capital across banks. The industry is working pro-actively and constructively with supervisors to address the specific concerns cited as reasons for introducing a floor. The ABA supports the initiatives of the IIF RWA Task Force and European Banking Authority to improve the comparability and consistency of Internal Ratings-Based Approach (IRB) models across institutions. The ABA supports the range of other initiatives being developed or implemented by the Committee which will also address concerns identified in the CD.

While excessive variability must be addressed, it is important to preserve as the primary method of allocating capital, a framework which takes into account all available information to more accurately calibrate risks. Improvements can be made to the current framework and, as noted, the industry is already contributing constructively to those improvements. Given the above, the ABA supports the continued application of IRB as the prime method for determining bank capital requirements and believes that initiatives underway will address the concerns of the Committee and potentially negate the need for a permanent floor.

On the basis that the prime method for determining bank capital requirements is the IRB method, a capital floor may then be considered necessary as a backstop measure. The CD proposes a capital floor based on standardised approaches. The ABA considers that the capital floor proposals cannot be considered separately from the revised standardised approaches or the further review of advanced approaches, both of which the Committee are separately undertaking. The ABA understands that the Committee intends to publish the final standard for a capital floor, including the calibration and implementation arrangements, around the end of 2015. The ABA considers it necessary to firstly agree the revised standardised approach

before the capital floor framework can be finalised and appropriately calibrated. The consideration of floors in any new framework should be the last step and should only, if required, be devised over a stable and internally consistent prudential framework.

The ABA believes the floor proposals as they currently stand, have significant design and calibration challenges that if not resolved, will only add to the complexity of the Basel framework. This works against the principles proposed by the BCBS Task Force on Simplicity & Comparability of pursuing simplicity where possible. The ABA is of the view that some of the objectives of the CD could be better met through these other BCBS initiatives alongside constraints on banks' IRB models (see Appendix). For example, minimum risk-weights could be applied to selected Basel asset classes that the Committee identifies as problematic while preserving IRB calculations for the large number of risk assets where robust data and modelling techniques are available. This approach would maintain the framework's incentives to continue to develop internal risk models.

The ABA welcomes the opportunity to make the following technical comments and highlights some challenges in implementing the proposed floor approaches. There is a very real risk of a potentially significant increase in complexity and the introduction of adverse incentives if the Committee decides to prematurely pursue one or more of the floor approaches proposed in the CD without properly considering the design issues identified

Design of the capital floor

If the proposed capital floor is pursued, care needs to be taken in its design to ensure that it is as effective as possible in meeting the stated objectives. While the move from a Basel I floor to the relatively more risk sensitive standardised Basel III floor is in principle a positive development, the ABA is concerned that there will be loss in risk sensitivity; this could result in an incentive for banks to take on higher risk exposures, as genuinely low risk businesses may be unduly penalised. For this reason, similar to the leverage ratio calibration, floors should represent a backstop measure, as there is a risk of unintended consequences to credit availability and customer pricing if requirements are not representative of the relevant risks.

The proposed floor, based on the standardised capital approach, lacks the risk sensitivity of an advanced approach. Take for example, two banks' lending entirely to regulated utilities, one on a secured basis (Bank A) and one on an unsecured basis (Bank B); Bank B would be expected to have more capital than Bank A. In contrast, under the current and proposed standardised approach to credit risk, these banks will have the same capital requirement. If a standardised floor is introduced which is binding on Bank A but not on Bank B, then Bank B's capital adequacy is still determined under an IRB approach, but Bank A must top up its capital requirement and will end up holding more capital than Bank B relative to the risk in its portfolio. It should be noted that unless the capital floor is binding on all banks, the above conclusions are valid irrespective of calibration. This is because:

- the capital floor will not distinguish between banks with legitimately lower capital requirements and those with unduly lower capital requirements; and
- a higher capital ratio does not always indicate prudence – banks with a higher risk portfolio will have more room to manipulate RWAs without hitting the capital floor.

Hence, the capital floor may penalise lower risk banks and create incentives for these banks to increase the risk in their portfolio. This is an example of the type of uni-directional behaviour that was highlighted by the Committee as a potential source of instability in the system¹.

Calibration

Appropriate calibration of any capital floor will be critical. If the Committee continues with the development of a revised capital floor based on a standardised approach, it should be done so in a manner which minimises negative consequences. If a floor is introduced, it should operate as a backstop only, the floor should not be calibrated in such a way as to be binding on all banks all of the time. It should instead be designed to capture some banks some of the time, and to incentivise the continued use of advanced approaches to risk management while preventing extreme variances from the standardised approaches.

Therefore, floors should be calibrated to ensure capital allocation and pricing remains appropriately calibrated to actual risk.

Significant effort has already been expended building, calibrating and implementing the IRB approach with the result of material improvements to the capital risk management and governance frameworks of banks. Focus should remain on updating IRB models to address model risk issues and improving assumption consistency by reducing material variations in key areas. The Committee should continue to support this work and prioritise it alongside revisions to the standardised approach.

One approach to minimising the risk of “missing” high risk portfolios is to set the capital floor such that it is binding on all banks. This has a number of obvious issues, the most material of which is the capital burden it would place on the industry.

The ABA believes that a principle which should be used to set the capital floor is that it should enforce the appropriate level of risk-weighted assets (**RWA**) to address the issue of model variability. The Committee should identify areas of sub-equivalence of RWAs both in relation to the Basel framework principles as well as modelling assumptions and concessions. Once the Committee has investigated these causes of sub-equivalence, should the Committee then determine a capital floor is the appropriate policy measure to target those causes; then that capital floor should be set at a level which removes this sub-equivalence.

The ABA also believes that as the shortcomings of IRB models are addressed and consistency of approach is improved, floors can be phased out over time. Floors should be transitional in nature and should be reassessed on a periodic basis to determine their continued usefulness in assuring capital adequacy, comparability and reliability.

Disclosure and comparability

The Committee's goal of improved comparability will only be achievable if the implementation and disclosure relating to a capital floor is applied consistently across all jurisdictions.

¹ Basel Committee on Banking Supervision, (July 2013) *Regulatory Consistency Assessment Programme (RCAP) Analysis of risk-weighted assets for credit risk in the banking book*: <http://www.bis.org/publ/bcbs256.pdf>

Standardised and simplified disclosure will be important to help the investor community compare and interpret adequacy levels. Allowing each national regulator to set their own parameters for capital floors will negate the guiding principles of simplicity and comparability; overly complicate an already complex framework and further compound the issues we face today around capital ratio harmonisation. A floor, where binding, would also need to be applied to banks disclosed RWAs, whereas today in some jurisdictions the disclosed RWA is applied before the application of the floor. The above issue can be demonstrated with reference to the application of the existing capital floor which has been differentially applied across jurisdictions, with different outcomes for capital disclosures. For example, some European countries (e.g. Sweden) apply the floor to minimum capital requirements rather than as a floor to RWAs. This means that the capital ratio disclosures of banks in these jurisdictions are based on RWAs that are not constrained by the floor. In contrast, US banks are subject to a capital floor that impacts their reported CET1 ratio.

The current lack of transparency over capital requirements combined with the use of national discretion has made it difficult for international investors to understand differences in relative capital strength across banks. In the Australian context, these subjective international comparisons have fed into a review of the financial system² that has recommended increasing capital levels of Australian banks based on a comparison of capital ratios in the data behind the BCBS Basel III monitoring report³. It is not clear whether the data in this report appropriately includes the impact of capital floors on banks, but assuming that it is based on the application of the current floor, and does not change the RWAs, means that Australian banks' capital ratios are being compared to those in other countries where the regulator has the capital floor as a "back-stop" (but does not impact on the reported ratio).

Responses to specific questions posed by the Consultative Document

Q1. Should the capital floor be applied to risk categories or as an aggregate floor?

Given the complexity of the proposals and in the absence of more detail on the calibration of each approach being determined, the ABA is at this time unable to confidently indicate a preference.

However, as an initial view, given the floor is intended to be a backstop to prevent capital requirements falling below a prudent level, it could be applied at the aggregate level. Outside of this, more sophisticated modelling of risk-weights should be driving business decisions. An aggregate floor would likely be easier to implement and explain to investors, and would give banks with different business models more flexibility in using the more sophisticated and risk sensitive IRB approaches to determine capital requirements. Maintaining this flexibility is essential for preventing instability as it will ensure that banks can maintain diversity in their business models.

The ABA strongly believes that a further round of consultation needs to be undertaken following the current QIS process and when calibration of any potential floor has been determined.

The ABA believes this calibration will highlight significant challenges with the floor proposals. If it was to be on an aggregate basis, not all jurisdictions have the same approach as to what is included in Pillar 1. For example, Interest Rate Risk in the Banking Book in Australia is in Pillar 1 and therefore a component of regulatory capital, while in other jurisdictions is in Pillar 2.

² Financial System Inquiry Final Report, (November 2014), <http://fsi.gov.au/publications/final-report/>

³ BCBS Basel III Monitoring Report, (September 2014), <http://www.bis.org/publ/bcbs289.pdf>

Q2. What are your views on the relative merits of the two options for adjusting for differences in the treatment of provisioning for credit risk?

The ABA agrees that a capital floor framework will need to allow adjustments for differences in the treatment of provisions. The Committee has suggested that adjustments could be made (a) by adjusting the numerator of the capital ratios for the expected loss versus eligible provisions deduction (**Option 1**) or (b) by adjusting provisions and converting them to a RWA equivalent (**Option 2**).

There are uncertainties on which is a better approach. It is hard to confidently model exactly how these options are intended to operate as the CD is not explicitly clear, and the examples provided do not cater for all situations. For instance, the example provided is for a situation with eligible provisions (**EP**) in excess of expected loss (**EL**), but Australian ADIs mainly have EL in excess of EP deductions. Also, the example provided is based on an aggregate floor, if the floors were based on risk categories it is unclear how the options would then operate.

Understanding that the ABA is seeking further detail on the options as currently proposed, a view is that comparability among standardised banks and IRB banks would possibly be greater under Option 1 (where adjustments are made to the capital calculation). This method also allows calculation of CET1 and T1 capital ratios under the floor, which is not possible if the adjustment is made through RWAs. Given investor and regulatory scrutiny of CET1, being able to apply the floor at this level seems to provide an advantage in meeting the objective of improving comparability across banks. However, standardised and IRB banks will not be fully comparable due to different risk infrastructure and risk environments.

The ABA notes that the adjustments for provisioning credit risk will need to differ in Australia as the Australian Prudential Regulation Authority (**APRA**) does not allow IRB banks to include excess provisions on defaulted exposures in Tier 2 capital.

Jurisdictional differences

A number of studies have been conducted by the Committee and the private sector which demonstrates there is variability in the capital ratios calculated by banks in various jurisdictions, as well as between the banks within a jurisdiction. Variability calls into question the appropriateness of the capital held by a bank as well as the ability to compare capital across banks, particularly the ability for investors and analysts to compare across banks.

However, the ABA argues that this cross jurisdiction variability is substantially influenced by two factors: (a) differences in the implementation of the Basel framework in various jurisdictions and (b) differences in modelling assumptions used, and concessions allowed, in various jurisdictions. There is a risk that if these factors are not recognised and addressed, any potential tool to address variability may not be suitable or have significant unintended consequences, particularly if any floor mechanism is designed in a too heavy-handed way.

In the ABA's view, these differences in the implementation of the Basel framework in various jurisdictions, needs to be addressed. In the Regulatory Capital Assessment Programme (**RCAP**) reviews, the BCBS should identify areas of sub-equivalence in relation to RWAs. If sub-equivalence is identified, the Committee should seek the application of the Basel framework principles.

The ongoing BCBS programme of benchmarking studies should seek to identify differences in modelling assumptions used and concessions allowed. Modelling assumptions and concessions which are not consistent with the Basel framework principles should be addressed. However, even if the Basel framework principles are silent on a matter (which is often the reason why modelling assumptions are allowed); those which create variability should be identified and addressed.

In its current form, the proposed floor underestimates comparability problems arising from supervisors taking different approaches to implementing the Basel standards. In the best case scenario, comparability between banks in different jurisdictions will remain poor. The proposals also have the potential to inappropriately bind the business operations and portfolio choices of banks based solely on the extent to which one supervisor chooses to impose more conservative Pillar 1 requirements while another supervisor uses Pillar 2 to impose higher capital ratios.

In Australia, APRA is significantly more conservative than the Basel framework in a number of areas, as highlighted in the recent RCAP. This includes 100% deductions from capital for all deferred tax assets and equity investments, rather than only applying deductions after the thresholds set out in the Basel III framework. As a result of these divergences from the international framework, the capital ratios of Australian banks will continue to be difficult to compare to international banks, even with the proposed capital floor in place.

It is difficult to compare across jurisdictions due to jurisdictional differences. A floor based on, and reported on, each countries implementation may give the illusion of comparability, but in fact preserves incomparability. Given these comparability issues would persist under the proposed floor, a better approach would be one that directly addresses the problem of regulators applying different standards, including the ongoing improvements to IRB models, so that risk sensitive capital ratios are more robust and comparable across banks. The ABA is strongly of the view that any revised floor should be based on the minimum standards set out in the Basel framework, not the approach of individual regulators. This would improve international comparability of banks' capital ratios and ensure that Australian banks are not being held to a higher floor than banks in other jurisdictions.

Implementation & transition

The ABA has concerns that the completion of the proposed floor by the end 2015 is a very aggressive timetable, given the dependencies on the completion of the revised standardised approaches.

Equally, there is the potential for unintended consequences if another comprehensive impact assessment is not undertaken prior to determination of the level of calibration of the floor. Once a second impact assessment is completed, it is important that banks have the opportunity to provide comments on any proposed calibration. This second round of consultations on capital floors, once there is clarity on the standardised approach, would ensure these unintended consequences are minimised.

In addition, given the application of the capital floor will require IRB banks to apply both the standardised and advanced capital treatments with associated data and systems implications, the ABA recommends that sufficient lead time is given to allow this infrastructure to be designed, built, tested and operationalised.

Most importantly, and in addition to the above, implementation of a new capital floor based on the revised standardised approach may require additional capital. There needs to be a sufficiently long time horizon for implementation to allow a transition to higher capital levels without oversaturating the market, preventing market instability and significantly increased funding costs.

One potential solution which maintains focus on the issue of RWA variability and comparability while allowing the Committee the time to address the underlying problems in an orderly sequence; would be to institute parallel reporting of capital adequacy under both the standardised and internal model based approaches. This would demonstrate the extent of variance between the two approaches and provide a basis for banks and supervisors to progressively identify and eliminate unwarranted variance.

Such a solution would require banks to run two systems to calculate each of the IRB and standardised calculations thus incurring significant system and resourcing costs. Therefore, should parallel reporting be considered, ABA believes that reporting should be limited to an annual exercise. The data and calculations should not be publicly disclosed as analysts and investors may misunderstand the information, which may have a significant impact on the cost of equity and debt before the Committee's reviews are finalised. The final calibration of the floor, should it still be judged to be necessary, would also be simpler and more transparent.

The ABA would also like to express our support for the submissions of the International Banking Federation and the Institute of International Finance, as we are broadly aligned as an industry with the key messages expressed in their feedback.

Thank you for taking our comments into consideration, and we look forward to future discussions on these issues.

Yours sincerely,



Aidan O'Shaughnessy

Appendix

Alternative approaches

The ABA supports the continued application of the IRB approach as the prime method for determining bank capital. The ABA supports both the IIF RWA Task Force⁴ and European Banking Authority⁵ initiatives to improve the comparability and consistency of IRB models across institutions. While the proposed standardised approaches are more risk sensitive than the current standardised methods, it is the ABA's view that they remain too blunt to be a basis for a capital floor. Rather, regulators should utilise the current advanced approaches but with limitations on the flexibility of these approaches by applying minimum risk-weights.

In addition to addressing or mitigating most of the issues with the capital floor raised in the main submission, this approach has two key advantages:

- it more directly addresses the concern regarding undue optimism in internal modelling; and
- it maintains the focus and relevance of advanced models.

The latter point is important, since internal models are highly desirable for both banks and regulators from a risk management perspective. While the CD contemplates the capital floor operating in conjunction with internal models, the introduction of a floor based on a standardised capital approach will lead to a redirection of industry and regulatory resources away from the ongoing focus on the development and use of internal models. This is not to suggest that banks only invest in internal models to the extent they support lower capital requirement. Making use of internal models for regulatory capital purposes imposes significant additional costs not incurred when the same models are used solely for internal purposes. While an ADI will have its own governance and review processes to ensure effective management of a model risk, in order to satisfy itself and its supervisor that models are fit for use for regulatory capital purposes, there will inevitably be significant additional requirements, such as commissioning additional external audits or consultant reviews and meeting additional data and analysis requests from the supervisor. In practice these additional requirements result in significant additional costs for IRB banks.

It is only sensible to carry these additional costs on behalf of supervisors if the regulatory community allows the output of the internal models to play a role in setting appropriate capital requirements. Outcomes in which capital requirements are ultimately bound by simplistic approaches with no or limited risk sensitivity, call into question the whole point of maintaining the investment in the additional processes currently required to govern the use of internal models in determining appropriate capital requirements.

With the increased requirement for banks to develop stress-testing scenarios and ensure that the level of capital is appropriate, banks will continue to use internal models for this purpose as the revised standardised approach is not sufficiently robust to entertain a proper assessment of capital in a period of stress. The result would be that the relationship between the capital calculated using the floor, versus the models, will not enable third parties to assess the quality of the capital buffer.

⁴ <https://www.iif.com/advocacy/committees>

⁵ http://www.eba.europa.eu/news-press/calendar?p_p_id=8&_8_struts_action=%2Fcalendar%2Fview_event%2FeventId=1003457