Bangkok Bank

June 24, 2016

Mr. William Coen
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2, CH-4002 Basel
Switzerland
e-mail : baselcommittee@bis.org

Re: Comments on the BCBS consultative document on "reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches" ("the CD")

Dear Secretary General Coen,

Bangkok Bank Public Company Limited ("the Bank") appreciates this opportunity to comment on the March 2016, the consultative document issued by the Basel Committee on Banking Supervision ("the Committee"), reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches.

The Bank fully supports the Committee's goal to reduce credit RWA variance and to strengthen the overall regulatory capital framework. We also recognized that there are certain sectors as well as particular groups of, so-called, low risk corporates where models may be difficult to justify as highly predictive due to low defaults statistics; however, we are highly concerned about the Committee's proposal to swiftly move to replace those suspected model shortcomings with the less risk sensitive Standardised Approach together with additional multiple floors concept. Such a proposed treatment would create anomalies which would generally penalize those high credit quality portfolio and would, contrary to the Committee's objective set out in the proposed CD, result in even higher risk portfolio within the Bank. We still see room for a less complex and a simpler solution to be still sufficiently risk sensitive. In addition, we see the need to better calibrate the overall capital requirements and abstain from unjustified mark ups. Finally, we are missing a usability test as a lot of the elements may be theoretically a good idea but lack adequate potential for practical implementation due to missing data and missing processing possibilities.

General Comments

The Bank strongly supports the Committee approach to balance out simplicity and risk sensitivity. However, we disagree that this intent has been reached in a sufficient manner with the current CD proposal. Not only is the proposal getting less simple and more complex than the current framework but we also do not see real risk sensitivity being reached. In line with the general BCBS guiding principles as formulated in the discussion paper "The regulatory framework: balancing risk sensitivity, simplicity and comparability", we would like to point out that stability over time is also needed. As such, we urge the BCBS once more to consider carefully whether amendments in the framework are necessary for the currently discussed topic but also more in general. Basel I capital framework, being simple but undervaluing risk sensitivity, prevailed and promoted distortive incentives in the pre-crisis years. On the contrary, a subsequent move to a more risk sensitive Basel II and Basel III have generated a huge improvement in risk management and greatly empowered the role of risk function within the bank. The banking industry risk management has greatly evolved since the implementation of Basel II and Basel III. Naturally, there were some hiccups here and there particularly when crisis hit, but that should be considered as a learning curve, patching such mistakes and move forward, with gains which should be maintained and enhanced further.

From our observation, the commercial banking system in general has significantly evolved in various dimensions towards BCBS objectives. At the same time, top managements of most of the commercial banks have realized the importance of internal risk management and expanded the usage of capital requirements and internal credit models to cover various aspects of internal bank management e.g. defining risk premium for each individual customer, risk-adjusted return on capital (RAROC), risk-adjusted performance-based evaluation, defining internal incentives and strategic planning, etc. Hence, it is apparent that banks did not solely adopt Basel II principle only to calculate the bank's capital requirement. Therefore, any proposed changes in such principle, the Committee should take into consideration its impacts on the expanded usage of such changes also.

- Concerning the comment on the CD, the Bank understands that BCBS expects neither issues from other guidelines nor issues from other consultative documents, to be commented together with the comments specifically targeted at the CD. Nevertheless, the Bank considers the concerns/issues from the recently published BCBS consultative documents as well as the final versions were inevitably tied to one another. Therefore, it is very essential to examine them collectively and holistically, rather than consider on a silo basis especially when it comes to the total impact on additional capital requirements for banks, even though the Committee declines such objectives and eventual impacts. Framework such as IRB and SA cannot be separately considered especially when capital floor will (if introduced) tied them together. And some of the changes are introducing "conflict" against even those BCBS original objectives, especially simplicity and risk sensitivity. The conflict and the changes, bringing impacts on banks and bank strategy, would obviously destabilize the aforementioned stable environment.

- The Bank would rather seriously request BCBS to thoroughly consider more comprehensive solutions/enhancements/changes from the root cause perspective. For example, if the problem is caused by the credibility of the model, the fix should be focused on calibrating the model. If the issue is caused by over attempting to optimize the RWA to, in turn, optimize the capital requirement, to fix the issue BCBS should directly address the concerns to the banks or their supervisor, utilizing the guidelines already put in place; and stringent enforcement should be restored, wherever neglected. Instead of addressing the root causes, and proposing a swift change back to the starting point and abandoning its own original principles, would penalize banks, who have sincerely adopted the concepts. Mixing the internal model with capital floor or multiple floors along with Standardised Approach would only bring about the comparability objective and ignore the rest; and would make Basel standard as only compliance issues for banks instead of promoting better risk management for the banking industry.

  In addition, the Bank would like to emphasize that the key principle of risk management is "accuracy", not "conservatism". If conservatism takes precedence over accuracy, it would definitely be adding more risk to the banks' portfolios instead of reducing risk. This is because it will penalize the high credit quality (lower-risk) customers and will inadvertently reward the less creditworthy customers. As a result, the high credit quality (low risk) customers would go elsewhere to whoever give lower pricing according to their risk, possibly those who are not bound under Basel standards or Shadow Banking, the bank would, therefore, be left with less diversified higher risk portfolio.

- The proposed CD addresses changes to IRB in three principles: i) Scope of use of internal models, ii) Parameter floors and iii) Parameters estimation practices and fixed supervisory parameters, including BCBS' intention of subsequent revision consequential amendments (particularly paragraphs 256-263 of Basel II) necessary to promote consistency in the framework, while at the same time, the Basel Committee's Use Test requires banks to explicitly demonstrate that the "IRB components" of PD, EAD and LGD used in regulatory capital are also employed for internal purposes, notably (i) strategy and planning processes, (ii) credit exposure measurement and management (including pricing and remuneration), and (iii) reporting as well. The Bank would like to urge the Committee to also review and revise other guidelines beyond paragraph 256-263 of Basel II to restore the Basel framework consistency, where they are touched by such changes. Where banks have great technical capacity to measure risk, it is fundamentally important that this be embedded and aligned with core metrics inherent in banks' decision-making. Those issues are as follow :-
    - Use of internal ratings: Basel II framework required IRB Banks to use internal ratings and default and loss estimates as an essential role in the credit approval, risk management, internal capital allocations, and corporate governance, not only for the purpose of providing IRB inputs to qualify for the IRB approach. The changes in this CD will have an impact on how those estimations such as the probability of default (PD) and the loss given default (LGD) are used in internal risk management processes. Risk estimations used for RWA capital calculation is no longer the same as those used in internal risk management. Therefore, the consistency in the framework objective, of the IRB banks, will be compromised.
    - Also, the requirements, prescribed by Basel II and adopted by Supervisors, to maintain the proportion of credit risk-weighted assets subject to the Standardised and IRB approaches, must have been reviewed and revisited too.
    - Moreover, with a wider spectrum, BCBS should take consideration of any impacts on other standards, such as the differences in certain relevant guidelines between the accounting standard, IFRS9, and Basel's IRB. We note that IFRS 9 has dramatically changed and strengthened the concept of Expected Credit Loss (ECL) requirements to promote greater use of internal model generated outputs for the purpose of accounting and provisions. However, it is to our great concerns that this CD seems to push capital calculations in the other direction. Such approach has the potential to introduce new complexities as banks, which are adopting the IFRS 9, will commonly use their existing IRB modeling capabilities as a base for addressing ECL requirements. The newly proposed CD capital framework will essentially result in risk-insensitive capital requirements while loan loss provisioning will be dynamic especially in the case where the modeled risk-weight is below the floored level, capital will not be sensitive to risk, but on a contrary provisioning will. This potentially creates a new gap between provisioning and risk-weighting, between

expected and unexpected losses, drastically compromise the progress of the last few years to align the accounting standards and regulatory capital perspectives.

Specific Comments

PD floor

The Bank has a preliminary concern on one of BCBS proposals – introducing PD floor that it will penalize those high creditworthy customers. The PD floor will force the high creditworthy customers to a higher PD, thus misallocating low-risk portfolios, consequently mispricing and banks will end up with higher-risk portfolios. Unavoidably, banks have to pass on more charges to these high creditworthy customers, implicitly forcing them to move to other financial institutes who can offer more accurate/better prices and leave those lower creditworthy customers behind. Consequently, the banks will end up with higher-risk portfolios. Besides, this will encourage more "shadow banking" businesses, due to some of the portfolios' PDs will be compromised by the PD floor. We are also concerned with the proposed 'output floor', which coming on top of the parameter floors and the Leverage Ratio creates an excessive and intricate construct of multiple 'backstop' measures, impeding the comparability of banks' underlying risk profiles and seemingly contradicting the Committee's desire for simplicity. In a variety of consultations we expressed our strong concerns about the concept of the leverage ratio, in particular, if the mandatory leverage ratio is not taking the business model into account. The solvency regime is based on risk sensitivity taking into account the riskiness of the assets. Mixing this approach with a back-stop regime like the leverage ratio (or at least should be although for many low risk / high volume banks it might become the primary regulatory constraint) is not sound.

- With similar rationales above, applying Standardised Approach for banks, other financial institutes, and large corporates with asset exceeding EUR 50 bn would bring a similar consequence, i.e. SA floor replacement applied, thus compromising the original IRB PD; and high creditworthy customers ending up being penalized.

  The disclosure according to Pillar III will be for compliance but may not accurately reflect the risk of portfolios and may not be in line with those used in internal risk management. Currently, Pillar III disclosures portray each banks' underlying risk-parameters (PD, EAD, LGD, CCF), and the distribution of portfolio across these, such that, by a simple comparison, an external party can understand the different risk-profiles. However, the proposed series of floors coupled with the different treatments across IRB and the SA will distort such comparisons, and could actually make the risk profiles of banks less comparable, contrary to the Committee's main objectives.

- Consequently, Bank of Thailand – the national supervisor and the other national supervisors may probably not be able to have an accurate picture of risk as a whole and subsequently may not be able to manage risk effectively.

Low-default exposures

As BCBS defined banks, other financial institutions, and large corporates belonging to consolidated groups with total assets exceeding EUR 50 bn as low-default exposures which would be subject to the Standardised Approach, mainly due to data insufficiency resulting in unreliable models and unreliable estimates.

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- Given the "Criteria for assessing modellability" on page 3 of the CD, the Bank would like to have a better understanding on what rationales and details in those criteria are deployed to exactly determine the modellability. For example, how BCBS judges whether data availability is sufficient or insufficient, what the decency of modeling techniques and validation looks like, how BCBS judges whether the modeling techniques and validation is sufficient or insufficient, etc. The detailed explanation would greatly enable the Bank to be able to perform self-assessment to a certain extent.

- Again, considering the constraints of building a reliable model for low-default exposure, and its result of unreliable estimates, the Bank believes that BCBS should have other alternatives e.g. pool data, segmentation, etc. to handle such modeling problem instead of totally abandoning the IRB and falling back to Standardised Approach. From the Bank perspective, by fixing the modeling problem is considered as fixing the problem at the root cause.

- "Exposures to corporates belonging to consolidated groups with total assets exceeding EUR 50 bn would be subject to the Standardised Approach". Some subsidiaries of certain groups may lend themselves for thorough credit evaluation. If BCBS chooses to collectively assign SA treatment on the whole group, this would compromise the intention of BCBS in promoting greater risk sensitivity. The reason is that some subsidiaries may impose greater risks to system even though they belong to the "low default exposure" group.

- BCBS uses "total asset and annual revenue" as a criterion to determine RWA calculation and convinces the Bank that BCBS focuses on reducing complexity and increasing comparability, but neglecting the risk management consistency. This is because "total asset" and "annual revenue" are relatively dynamic in nature and will result in inconsistency in RWA calculation approaches. For example, in the beginning, an exposure is initially calculated by AIRB, and with the change in either "total asset" or "annual revenue", the Bank has to change the RWA calculation approach to either FIRB, or Standardised Approach.

- Where low default portfolios are characterized by a lack of historical losses, this certainly does make it difficult to be precise, but it also reflects the fact that, by their nature of definition, those assets are relatively low risk. We are concerned that where the treatments set out in the Consultative Document would create anomalies. Those anomalies will generally be concentrated against the better-quality borrowers and result in greater credit risk for the banking industry.

<u>Definition related Clarifications</u>

- "Consolidated groups", BCBS uses the term to aggregate "large corporates" together. The Banks are not exactly sure whether the term "consolidated groups" definition goes by accounting standard or national supervisor standard.

- We would ask the Committee to clarify that the references to "other financials" in this proposal should be interpreted in the light of that explanation. This is important, because in certain regulatory inclined to treat alternative investment funds including, private equity real estate firms as “financials”. While there may be circumstances in which that approach is appropriate, based on the explanation the Committee gives for this proposal, this is not such a case: alternative investment funds would not generally be regarded as having low-default status, and are rarely externally rated, subject to significant market analysis.

Conclusion

The Bank recognizes that some of models currently used are inherently imperfect, and that banks must continue to improve, enhance and rigorously scrutinize its internal model on an on-going basis, however, they should not be totally disregarded, as we believe that they remain the best available option for estimating the true underlying risks across banks' portfolios and besides its inherent flawed, there remains tremendous benefited that banking industry used as a main vehicles to improve its risk management.

Finally, it should be emphasized that the Bank are highly concerned that the cumulative impact of all CDs – both currently-proposed and already-finalized ones - will jeopardize the role of the bank in supporting the economy. The Bank welcomes the past commitment by the Group of Governors and Heads of Supervision as well as the governor of BCBS to not seek to significantly increase capital requirements. If such proposal be implemented as its current form and merit, it would undoubtedly result in substantial impact on banking industry on the way the banks conduct their business due to higher capital requirement. More importantly, both developed and emerging economies which lack of the depth of capital market and still heavily rely on banks as the main source of funding would be negatively affected by the funding availability and pricing of credit to the economy.

For your kind consideration.

Ayuth Krishnamara
Executive Vice President
Head of Risk Management Division
Bangkok Bank PCL