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Dear Sir / Madam

Capital floors: the design of a framework based on standardized approaches

We appreciate the opportunity to comment on the Basel Committee on Banking Supervision (BCBS) consultative document "*Capital floors: the design of a framework based on standardized approaches*".

We acknowledge the intention of the BCBS to implement a revised capital floor framework; however, we strongly question the conceptual soundness of capital floors being introduced as part of the regulatory framework to enhance comparability. We believe it is incorrect to seek comparability through standardisation but rather the aim should be to seek to compare the true risk profile of institutions as risks invariably vary from institution to institution and from jurisdiction to jurisdiction.

Our response to BCBS 258 "*The Regulatory Framework: Balancing Risk Sensitivity, Simplicity and Comparability*" dated 17 October 2013 reaffirms this approach.

The 1988 BCBS "*International convergence of capital measurement and capital standards*" introduced a simple non-risk based Basel I framework. This framework was substantially rewritten in 2006 as a revised standard, Basel II with the specific objective to "...promote the adoption of stronger risk management practices by the banking industry, and views this as one of its major benefits".

The potential for rapid capital depletion on a global scale introduced by the new Basel II standard, necessitated a capital backstop to ensure that global capital levels remained constant and underpinned the new Basel II banking sector, despite the potential capital savings of moving to more sophisticated, risk based capital calculations. The capital floor using the Basel I standardised approach was introduced as a temporary measure, until a package of reforms was announced in July 2009 in response to the global financial crisis, making the capital floor a permanent feature of the Basel framework.

In South Africa, where Basel II has been adopted within the international timelines and our Central Bank has committed to fully implementing the Basel III framework, the challenge of comparability on simple measures is well documented in a failure of a medium sized South African bank during 2014, unrelated to the international financial crisis. Despite substantial capital adequacy levels of 32%, above the regulatory minimum capital requirement of 10.5%, the bank through a BCBS lens of comparability of capital outcomes appeared more resilient than most other banks, yet it required government support in an environment of more sophisticated risk management and supervision. Within a global scale of capital equivalence this comparability may also fail.

The aggressive promotion of new international standards remain untested and in combination with recover and resolution plans, public disclosure and other measures designed to make the banking sector more resilient, it would seem unlikely that the same amount of asymmetric information would exist in a post reform era.

What is important for our emerging market franchise is to be able to provide banking services to our citizens at a price that they can afford. The regulatory cost of a more sophisticated risk management approach, in an environment of complex banking products is understandable, however the additional costs of perfecting the system through capital floors, leverage ratios, central clearing, deposit insurance and many other prudent measures and the reporting obligations that flow from these measures may increase the cost of financial inclusion to a point that is no longer sustainable. We believe that the calibration of these proposals should be carefully weighed against the economic impact that such proposals may have on the real economy.

Furthermore, we believe that it would be premature to articulate a preference in relation to the relative merits of risk category-based and aggregate risk weighted asset-based floors in the absence of the finalisation of standardised approaches and calibration of floors, as well as an impact analysis in this regard.

We disagree with capital floors that fail to distinguish between the levels of risks and render the use of models redundant. Modelled risk weighted assets (RWAs) may legitimately be lower than standardised RWAs where the model has more explanatory power.

Models still have an important role to play in terms of fostering risk management, understanding of risk and guarding against herd behaviour. An explicit floor will provide banks with a clear base for a cost-benefit decision for the implementation of these more advanced models. However, the calibration of floors needs to give incentives to banks to go for the more risk sensitive approaches.

We do not share the BCBS view that the proposed capital floors complement the existing leverage ratio regime. We would suggest that further analysis is required on the overlap between capital floors and the leverage ratio before such a conclusion can be made. The BCBS proposed timing to finalise standards by the end of 2015 seems ambitious as key elements of the new capital regime are still under development. These elements should in our view be finalised before capital floors can be calibrated.

We shall provide answers to the three questions posed below.

Add: Question 1:

Assuming the respective floors were calibrated to achieve the same level of required capital, what are your views on the relative merits of a risk category-based floors and an aggregate RWA-based floor? What are your views on a floor based on exposure class?

For a given level of required capital, current regulations are able to address the requirement already. A floor would result in an increase of the capital levels above the required level of capital. The more granular (and therefore less practical) the floor becomes the smaller this over estimation of required capital will be.

In our view, it is premature to form an opinion on whether one floor type would be preferred over another given that the standardised approaches are currently in consultation and the calibration of the floors is unknown.

An aggregate floor would be less complex and costly compared to a risk category-based floor. Our preference would be for a floor that applies on an exceptional basis only.

A challenge with an aggregated floor is the lack of coherence between the standardised and advanced approaches in each of the risk categories. If the standardised floor framework allows cross-subsidisation as a principle, the consultative floor proposal suggests higher overall calibration. Therefore, we support the concept of applying floors at the level of major risk categories to give scope for a differential calibration. In other words, if credit and operational risk proposals for standardised approaches remained as risk-insensitive as proposed, we would prefer lower floors to apply to them individually.

Add Question 2:

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

Regarding relative merits: Option 1 seems to be more exact while Option 2 seems to be more aligned with the intention of applying a standardised floor to RWAs.

In our view, both approaches would be feasible for either an aggregated or by major risk type floor. Should the BCBS decide to implement floors by major risk categories then the calculations would become more complex for both options 1 and 2.

It would be helpful if the BCBS provided some examples for how different floor factors could be applied to the stylised example provided in Box 2 of the consultative paper. The stylised example is comprehensive in how adjustments to RWAs and regulatory capital are applied but it lacks transparency of how floors would practically be applied.

Differences in the treatment of provisions should be evaluated in light of changes to IFRS 9 that will be effective before implementation of the proposed capital floors. This particularly applies to the paragraph 60 of the Basel III standards that restricts the inclusion of general provisions in Tier 2 to a maximum of 1.25% of credit RWAs under the standardised approach for credit risk (SA-CR) and paragraph 61 of the Basel III standards that restricts the inclusion of excess provisions to 0.6% of credit RWAs under the IRB.

Add Question 3:

Do you have any other comments regarding the design of the capital floor?

Capital floors are not risk sensitive and may be to the detriment of valuable risk management practices supported by risk sensitive models. As an example, floors may incentivise financial institutions to seek an increase in risk when exposures are less risky than specified by these floors.

Capital floors can result in even higher capital requirements that will stunt growth in emerging markets further. The focus should be on improved risk assessment and means of addressing model risk instead of the implementation of capital floors across banks. We are of the view that the current Basel III proposals and associated reviews address this objective while capital floors do not.

The difficulty in setting a global level for the floors introduces additional complexity and will not necessarily achieve the simplicity sought. Capital floors provide poor risk assessments especially across jurisdictions, and should not be made a permanent component of the supervision framework.

We would suggest that the suite of policy tools available for supervisors is sufficiently wide and varied to address any potential capital shortfalls from modelled capital requirements. The role of Pillar 2 becomes unclear once the standardised floor is implemented. Under Pillar 2, economic capital becomes an important measure of a bank's internal view of capital. Often, Regulators require banks to reconcile the economic and regulatory view. The implementation of such a floor would further potentially further diverge regulatory capital from economic capital and the Pillar 2

process. It would therefore be challenging to pass the “use test” if such a standardised floor number is not used in portfolio and pricing decisions, which would often not be the preferred way of pricing products (on the binding constraint). Mispricing or discontinued businesses (that serve the real economy) cannot be ruled out at this point.

It is also further proposed that the BCBS should rather retain the risk-sensitive nature of RWA calculated on an advanced approach (for IRB accredited institutions). If a capital floor is implemented (to prevent levels of capital falling below the level where it is supportive of the underlying/intrinsic level of risk), the BCBS should rather consider adjusting the numerator (through a Pillar 2 add-on). This would have a similar outcome for banks (less capital to be deployed), but retain the risk-sensitive nature of existing models. We would caution against an approach where capital and the true risk profile of individual banks are divorced (see also previous point around Pillar 2 process with Regulators).

Moreover, should a new standard such as TLAC be implemented, it should not be based on the adjusted/standardised RWA. Adjusting the numerator, and not the denominator, would prevent such an unintended outcome.

If the decision is taken to implement the floor, it may be prudent to take a staggered approach. This would only be viable where the capital floor is calculated by risk type and adjusted in the denominator. In such a case, the BCBS should consider a phased approach where they start with a risk type, say, operational risk and then add another risk type until credit is added as the last Pillar 1 risk type. This would allow greater re-adjustment to the new requirement and afford banks the opportunity to enhance IT systems to cope with the additional dual reporting especially around lending.

It goes without saying that the additional requirement would add significant cost to banks. This is not only due to IT enhancements and dual data requirements, but also due to increased (external) audit and review costs. Given all the new disclosure requirements, and banks’ internal governance processes around these disclosure templates, it would add considerable timing pressure to complete all reviews on time.

The decision of the BCBS to apply a capital floor based on the standardised approach that exists in the jurisdiction where the bank operates seems to contradict the current approach where banks are required to comply with the countercyclical buffer add-on where the underlying exposure lies (and not the jurisdiction of the operation). The practical implications should be considered, given the complex overlay of the proposed buffer.

In light of the Basel Committee’s work on standardised approaches, a new scheme for capital floors should only be devised once all the changes envisioned have been finalised.

We hope that our comments will assist the Basel Committee on Banking Supervision in their deliberations and remain available to the BCBS should further information or clarity be required.

Yours faithfully



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