



The voice of banking
& financial services

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

Dear Sirs

The BBA is the leading trade association for the UK banking sector with 200 member banks headquartered in over 50 countries with operations in 180 jurisdictions worldwide. Eighty per cent of global systemically important banks are members of the BBA. As the representative of the world's largest international banking cluster the BBA is the voice of UK banking.

We have the largest and most comprehensive policy resources for banks in the UK and represent our members domestically, in Europe and on the global stage. Our network also includes over 80 of the world's leading financial and professional services organisations. Our members manage more than £7 trillion in UK banking assets, employ nearly half a million individuals nationally, contribute over £60 billion to the UK economy each year and lend over £150 billion to UK businesses.

The BBA is pleased to respond to this consultation.¹

Our response should be read in conjunction with the responses to the Committees' consultation paper: Revisions to the Standardised Approaches to Credit Risk, Operational Risk (already submitted) and Market Risk.

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¹ <http://www.bis.org/bcbs/publ/d306.pdf>

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Key messages

Our members support the Committee's stated objectives and agree that a review of the Basel 1 floor is needed.

However, we think that it would be more appropriate for the introduction and calibration of a new capital floor - if introduced - to be deferred until the Committee has finalised the revised standardised approaches, and once a dedicated quantitative impact study has been undertaken.

Sequencing in this regard is vital to ensuring that the objectives are met.

Our members are of the view that shortcomings of modelled approaches can be addressed directly through improvements in internal approaches themselves, or existing regulatory tools.

Recent regulatory initiatives such as benchmarking exercises and improvements to IRB assessment methodology could help to directly address the underlying concerns of the Committee and contribute towards advancement of the stated objectives.

Furthermore there already exist regulatory tools which can help to alleviate the concerns highlighted in the consultation. These include for example, the leverage ratio, the use of stress testing, pillar 2 requirements and sectoral capital requirements.

We recommend that it would be beneficial to evaluate the effectiveness of these tools before a floor is introduced.

We therefore think - if introduced - that the calibration of capital floors should continue to provide incentives for banks to continue to improve and use internal models and that it would be beneficial to promote an approach that seeks to minimise the delineation between banks' own risk management measurements and the approach to measuring risk from a regulatory perspective.

In the case that the Committee decides to proceed with a capital floor we recommend that it is used only as the determining factor for minimum capital requirements binding for outliers, rather than be the on-going constraint for a large population of banks.

The industry supports risk sensitive approaches remaining as the primary determinant of capital requirements

The introduction of a floor may remove the linkage between banks' own risk management and capital outcomes under floor.

To ensure that Risk-based capital ratios appropriately reflect the financial strength of banks it is necessary the ratios are reflective of risk levels to which the banks are exposed.

Therefore, we strongly support improvements in risk sensitivity as a fundamental principle underlying the overall regulatory capital framework and recommend that any introduction of capital floors continues to support this principle.

When compared to model based approaches, standardised approaches for determining capital requirements inherently have less risk sensitivity, although they benefit from simplicity.

Whilst we recognise that the proposed revisions to standardised approaches are intended to improve risk sensitivity, in general they do include all of beneficial impacts of genuine hedging and risk mitigation, and their global-one-size-fits-all nature does not allow differentiation of risk across jurisdictions which is caused by elements such as differing nature of their customer bases, market structures, legal frameworks etc.

A capital floor may reduce comparability of capital ratios between banks by de-emphasising the riskiness of a bank's exposures in the assessment of such ratios.

Furthermore, there currently exist national divergences in the implementation of standardised approaches; divergences that would (unless eliminated) be embedded into the capital floor, therefore reducing comparability.

Banks have invested an extensive amount of resources to develop, maintain and continually refine internal models. In certain instances variability of risk weights derived from the IRB models is justified and represents differences inherent in certain portfolios. For example geographical differences in the same asset class can lead to material differences in risk weights within a bank and across different banks.

Our members are of the view that shortcomings of internally modelled approaches could be addressed directly through improvements in internal approaches themselves, or existing regulatory tools. Recent regulatory initiatives such as benchmarking exercises and improvements to IRB assessment methodology may help to directly address the underlying concerns of the Committee and contribute towards advancement of the stated objectives.

Therefore, we think that reflecting risk sensitivity should be a key principle for determining risk-based minimum capital levels using a risk-based approach, with the Leverage ratio, and stress-testing acting as back-stops.

The timing for the finalisation of the design and calibration may need to be re-considered

The Committee has stated that it plans to complete the process to determine the calibration of a capital floor by the end of 2015.

There are currently many areas of regulatory change that need to be finalised before an impact assessment and calibration of the capital floor may be fully understood. These include:

- calibration of the Leverage ratio;
- revisions to the Standardised approach for Credit Risk;
- review of IRB models;
- impact of expected loss provisioning to comply with IFRS 9;
- finalisation of the revised standardised approach to Operational Risk, and;
- the finalisation of the Fundamental Review of the Trading Book

Therefore, we request the Committee to defer the calibration until the impacts of these changes are fully understood and supported by a dedicated impact study.

We suggest that the Committee take into account the timeframe needed to change legislation and therefore recommend that a binding date for implementation should not be before 1 January 2018.

The operation of a capital floor needs to be considered

It is necessary to understand the intended design and operation of the capital floor in order to assess its appropriateness and impact.

The consultation includes questions covering whether the capital floor should be risk-category based or in aggregate, and the treatment of provisions.

However there are many other design aspects of the proposed capital floor which have not been outlined which are extremely significant. Without a full outline of the proposed capital floors design, it is difficult to provide answers to the Committees questions.

In our view the capital floor could be defined as an “own funds requirement” consistent with the approach that has been adopted within the EU under Capital Requirement Regulation (CRR, Article 500).

This would mean that the floor - if binding - would specify an increase in the capital requirement and not change the reported RWAs and consequently not impact the other requirements in the regulatory framework such as the capital buffers or future TLAC requirements.

We also request the Committee to consider the complexity in the operation and calibration of the capital floor to take into account partial use of internal models in conjunction with Standardised Approaches.

The proposals may create new challenges for banks

As is noted by the Committee, the leverage ratio already exists as a back-stop and is intended to deal with many of the shortcomings set out in the consultation paper.

In addition, there already exist various floors at the portfolio level and for some portfolios banks are required to use standardised or foundation approaches by national regulators.

In some areas there also exist requirements to scale up RWA for exposure classes in which internal approaches generate low RWAs e.g. asset value correlation.

The imposition of a capital floor - in addition to existing measures - may add a further level of complexity to the management of balance sheets and capital if it is implemented in a way that it becomes the primary driver of risk measurement. This may also undermine the Committee's objective of simplicity.

We request the Committee takes these matters into account to ensure that a capital floor - if implemented - does indeed remain a backstop to achieve the Committee's objectives and does not supplant the Leverage Ratio and or the incentive to develop and use internal models (IRB and AMA).

Answers to questions

Q1. 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?

Our answer to this question is prefaced with assumption that the Committee strives to maintain a minimum overall capital in the global banking system and that it recognises that there will be idiosyncratic impacts on each bank and each regulatory jurisdiction that may result in over and or under-calibration.

There are advantages and disadvantages to each of the proposals.

Each proposal may have a different impact for single-point-of-entry (SPE) compared to multiple-point-of-entry (MPE) banks subject to multiple regulators, for example when a bank would be required to calculate capital floors at different levels of consolidation. We encourage the Committee to consider these matters also.

One of the challenges for either approach may be a lack of coherence between the standardised and internal modelled approaches in each of the risk categories.

- The Fundamental Review of the Trading Book, 'Sensitivity Based Approach' and the Standardised Approach to Counterparty Credit Risk have been designed as approximations of their internally modelled equivalents.
- However, the proposed revisions to the standardised approaches to Credit and Operational Risk (that have yet to be finalised) may not be sufficiently risk sensitive and or good proxies for RWA that would otherwise be calculated under IRB and AMA.

In the absence of further clarity of how the Committee proposes to determine, calibrate and use the capital floor(s); taking into account partial use of IRB; it is not possible for the industry to be definitive as to which of the approaches (aggregate v risk category) it prefers to achieve an objective of an appropriate, proportional and comparable overall minimum level of capital for all banks.

There are some members who favour an aggregate floor and others who favour floors calibrated for each risk category.

Aggregated floors

An aggregate approach may help to better deliver the Committee's objectives of the capital floor being simple and comparable. It would be a relatively simpler test to apply and would enable ease of comparison between banks.

It would also provide flexibility for banks and allow recognition of diversification across the major risk categories, whilst continuing to meet the Committee's objectives.

Floors by major risk category

Providing that the boundaries between the risk categories are clear (and this may not be straight-forward), possible merits of a floor imposed on a risk-category basis include:

- be more straightforward to calibrate because there would be no need to assess the correlation between the risk categories or to take into account multiple combinations of standardised approaches and internal models, and
- assist banks to manage risk within each major risk category,

Floors by Exposure class

We think that floors by each exposure class leads to a conclusion that the estimate of total losses derived from the Standardised Approaches can be compared with the estimates of unexpected losses derived from the Committee's IRB Credit Risk model.

The different modelling approaches (Standardised v IRB) may be useful as a benchmark, but we do not agree that these different approaches to modelling are directly comparable for each exposure class on a standalone basis.

We think that the alternative approaches to credit risk modelling (Standardised v IRB) are sufficiently different to undermine their use as a comparator at exposure class level.

In addition, it is possible that for some exposures only the standardised approach will be used thus adding complexity to the comparability for banks that calculate regulatory capital using a combination of standardised and internally modelled approaches.

This in turn could make implementation burdensome, increase the complexity of the framework and make the overall calibration challenging to take into account partial use of IRB models.

A more granular application may significantly increase the required disclosure without adding insight on a banks' risk profile.

In conclusion, we do not support floors by exposure class.

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?

Our view is that it makes sense to align the approach for the treatment of provisions with the approach to determining the capital floor (refer to the answer to Q3 below)

However we think that the examples provided are too simplistic and raise a number of questions and involve a number of assumptions in calculating the worked examples.

As a result, without further clarity we cannot provide a clear preference of one approach over the other.

Specifically, the examples do not take into account that general provisions do not arise under IAS 39 and the impact of expected changes to IFRS 9.

Furthermore the examples do not consider the situation where expected losses exceed provisions, and how such a shortfall would be reflected in either approach.

It is also essential to gain clarity on how the application of a capital floor is intended to feed into other areas of the regulatory framework.

We would encourage the Committee to review carefully our members' individual responses that set out detailed technical questions that we believe should be assessed before a final decision is made.

Q3. Do you have any other comments regarding the design of the capital floor?

Allowing sufficient time for calibration and implementation

We acknowledge the need to link the Committee's work to the FSB work-plan and in turn the G20 initiatives.

However, as stated above we encourage the Committee to allow time to conduct the various QIS and a sufficient implementation schedule to ensure that banks can adopt the new framework.

Unforeseen implications of the proposed revisions to the credit risk approaches

Our members - that have IRB permission - have identified that the proposed revisions to the Standardised Approach will lead to an overall increase in the minimum capital requirement relative to the IRB approach (on the basis that the IRB formulas remain unchanged).

However, we understand that the Committee is considering revising the IRB formula that may lead to an increase in the calculation of Risk Weighted Assets and thus overall minimum capital requirement for all banks.

We note that the no decisions have yet been taken with respect to the approach for exposures to Sovereigns.

The implications of these changes may have a profound impact upon the calibration as set out below.

Calibration

We think that the Committee's greatest challenge is to calibrate the estimate of losses derived from two very different approaches to modelling credit risk

- a) Committee's standardised models - an estimate of total loss and
- b) IRB models - an estimate of unexpected losses,

as well as to take into account the treatment of the adjustment to provisions to achieve comparability.

Overlap with the leverage ratio

We note the well-documented overlap between the objectives of the Leverage Ratio and capital floor. The Leverage Ratio is considered by the industry to be the primary back-stop.

Therefore our preference is that any capital floor is calibrated in a way that it would not be binding in the majority of cases, but would most likely impact in only exceptional cases where the calculations derived from internal models would give rise to outliers when compared with standardised calculations.

Support for internal models to remain important contributors to the capital framework

We think that it is important that the Committee recognises that the Credit Risk IRB, internal market risk models and the Operational Risk AMA remain important contributors to the prudential capital framework.

We encourage the Committee to choose a calibration of the capital floor (whichever approach the Committee chooses) that provides an incentive for banks to retain and adopt the credit risk IRB and AMA models.

We also believe that the implementation and calibration needs to take account of on-going developments to the IRB framework, in particular the IRB model CP due in mid-2015.

Capital floor as a separate additional own funds requirement

In our view it would be preferable to introduce a capital floor as a separate additional own funds requirement, which does not impact other regulatory requirements such as capital buffers, TLAC requirements, large exposures etc.

The Capital floor would then not be a mechanical substitution for RWAs when it is a binding constraint.

The alternative approach is to replace modelled RWAs with those calculated using the Standardised floor (if higher). We would not support such an approach. This would have a very wide-ranging impact covering risk based capital ratios, the minimum levels for such ratios and also TLAC requirements. In other words, in view of the on-going work to calibrate the level of TLAC we would request the Committee to explicitly exclude compliance with a capital floor having any impact upon the calculation of TLAC.

The existing EU capital floors approach is considered preferable as capital ratios would be calculated and disclosed consistently with existing risk sensitive methodologies.

If, as an alternative, RWAs are revised this approach would act as a blunt instrument that would weaken the value and comparability of the risk-based ratios. We would be concerned if the floor simply creates an artificial alignment of risk weights that lacks risk sensitivity and becomes disconnected from IRB and AMA modelled-based capital requirements.

Avoidance of unnecessary disclosure

We note that in paragraph 27 the Committee has stated that *“to ensure that the floor is transparent and robust, banks would disclose the impact of the floor on capital ratios”*.

If a floor was binding, the resulting reduction in capital ratio would need to be extensively explained.

An implementation of the capital floor as described above - would obviate the need for this disclosure. Instead there could be an explanation by the institution as to how minimum requirements have been impacted by a capital floor.