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Basel Committee on Banking Supervision
C/- Bank for International Settlements



Dear Sirs

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

Commonwealth Bank is the leading financial services provider in Australia, with total assets of over A\$850 billion supported by a Common Equity Tier 1 capital ratio of 13.3% on an internationally comparable basis and 9.2% on a local basis.

We are supportive of the BCBS work program to reduce variability in the calculation of bank capital ratios and therefore to enhance the reliability and comparability of capital across banks. As demonstrated by the preceding paragraph, we currently calculate and publish two sets of capital ratios for the benefit of investors to ensure investors can appropriately compare us against our international peers. This is critical to our ability to efficiently raise capital and funding in globalized markets.

We refer to the consultative document entitled "Capital floors: the design of a framework based on standardized approaches" published by the Basel Committee on Banking Supervision (BCBS) in December 2014.

We support the submission on the consultative document made by the Australian Bankers' Association. In addition, we provide this short submission with specific comments on some aspects of the proposals.

Key principles

A number of studies have been conducted by the BCBS and the private sector which demonstrates there is variability in the capital ratios calculated by banks in different BCBS jurisdictions as well as between the banks within the same jurisdiction.

Commonwealth Bank believes that this variability is due to 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 both factors are not recognised and addressed, any potential tool to address

variability may not be suitable or have unintended consequences, including that the mechanism may be designed in too heavy-handed a way.

In our view, differences in the implementation of the Basel Framework in various jurisdictions need to be addressed. In Regulatory Capital Assessment Programme (RCAP) reviews, the BCBS should identify areas of sub-equivalence in relation to risk-weighted assets (RWAs). If sub-equivalence is identified, the BCBS should then enforce the Basel Framework principles. We discuss this concept of “enforcement” of the Basel Framework further under the heading “Calibration” below.

Further, in RCAP reviews, the BCBS should identify differences in modelling assumptions used and concessions allowed. Modelling assumptions and concessions which are not consistent with the Basel Framework principles should obviously 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.

We acknowledge it may be felt that the RCAP cannot address the issues raised above and that a simpler mechanism may be needed such as a floor. If this is the case then, in our view, the purpose of a floor should be to act as a back-stop mechanism; not to become the primary driver of capital ratios. This is important because of the benefits arising from the use of internally-modelled approaches, including the discipline of the detailed analysis of risk which encourages better risk management. If a floor became the primary driver, then it would not be necessary to conduct such a detailed analysis and risk management practices may change.

Design of the capital floor

The BCBS has suggested that the capital floor could be applied to (a) major risk categories, (b) major exposure classes, or (c) based on total RWAs (ie, be an aggregate floor). At this stage, in the absence of more detail on calibration, Commonwealth Bank believes that an aggregate floor has the advantages of being simpler to operationalise and easier to communicate to investors and analysts. If calibrated correctly, the benefits of both a risk category-based floor and an exposure class-based floor should still be achieved through the single aggregate measure.

Commonwealth Bank agrees that the capital floor framework will need to allow adjustments for differences in the treatment of provisions. The BCBS 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”).

We prefer Option 1. This option is a more precise methodology as it converts the capital ratio calculation into a standardised format and is a simpler adjustment. Under Option 2, the denominator of the capital ratios would be adjusted for provisions but there would also need to be an adjustment to the numerator to avoid a double count of provisions (ie, for the deduction for the amount of expected losses over provisions). This would be consistent with the application of the Basel I floor which applied in Australia until 2011 as part of the implementation of the Basel Framework and Basel II. The multiple adjustments under Option 2 are likely to be difficult for investors and analysts

to understand. The Option 2 example in the Consultative Document does not adjust the numerator, which appears to be an error.

We note that, if the capital floor is a risk category-based floor or an exposure class-based floor, then it would be complex to make adjustments for provisions as they may have to be adjusted at the risk category or exposure class level.

Calibration

Commonwealth Bank notes that appropriate calibration of the capital floor will be critical. On the one hand, the capital floor ratio should not be set so low that it does not have any impact causing banks to calculate meaningless standardised capital ratios.

However, the capital floor should not be set so high that it becomes the primary driver of capital ratios. The capital floor should be calibrated to ensure there remains incentive to use a more risk-sensitive approach based on internally modelled approaches. Significant effort has been expended building, calibrating and implementing the internally modelled approaches with the result of material improvements to risk management frameworks.

We believe that the principle which should be used to set the capital floor is that it should enforce the appropriate level of RWAs to deal with the issue of model variability. The BCBS should identify areas of sub-equivalence in relation to RWAs, both sub-equivalence in relation to the Basel Framework principles as well as modelling assumptions and concessions. The capital floor should then be set at a level which removes this sub-equivalence. It should be noted that the capital floor should still be set as an aggregate floor for ease of implementation; there does not need to be a capital floor for each area of sub-equivalence.

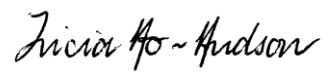
Implementation and transition

The BCBS intends to publish the final standard for a capital floor, including the calibration and implementation arrangements, around the end of 2015. Commonwealth Bank believes this timeline is too short, as it is necessary to first agree the revised standardised approach before the capital floor can be designed and calibrated. A second round of consultations once there is further clarity on the standardised approach will ensure any unintended consequences are avoided. This round of consultation needs to consider the length of time necessary to build out our datasets and modelling infrastructures to support the standardised approach.

In addition to the time necessary to build measurement capability, implementation of a new capital floor based on the revised standardised approach may require additional capital. There needs to be sufficiently long time horizons for implementation to allow transition to higher capital levels without oversaturating the market, preventing market instability and significantly increased funding costs.

We thank you for taking our comments into consideration and would be happy to answer any queries you may have.

Yours sincerely

A handwritten signature in black ink, reading "Tricia Ho-Hudson". The signature is written in a cursive, flowing style.

Tricia Ho-Hudson

Head of Capital and Regulatory Strategy
Commonwealth Bank of Australia Group