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EBF response to the BCBS consultation on Capital floors: the design of a framework based on standardised approaches

EBF comments

The European Banking Federation (EBF) appreciates this opportunity to comment on the Basel Committee on Banking Supervision (BCBS) proposal to revise the Basel standard on capital requirements, and share with you our views on the proposed framework of capital floors based on standardised approaches.

Overall, we are concerned with the proliferation of different sorts of floors in the capital requirements framework. We also believe that the sophisticated set of floors proposed does not contribute to achieving the desired simplicity. We understand that the Basel Committee seeks to address the perceived problems associated with the variability of internal risk model results. However, we believe that objective should be pursued without impeding the valuable risk management practices that support the use of risk sensitive models.

We are especially concerned with the following aspects:

- A stringent floors framework could remove the incentives for strengthening risk management.
- The proposed approach appears to primarily focus on a new Standardised Approach purely to provide a new floor. Building a modelling system with this approach does not coincide with improved risk management practices.
- To build such a proposed floor system would be resource intensive and to maintain it would be equally so, with dubious risk management benefit.

The floor must be designed to be consistent with the rest of the Basel III framework. The framework already contains a backstop on capital through the leverage ratio. The introduction of a revised Basel floor as a backstop on capital therefore seems superfluous.

As the Basel Committee is undertaking a quantitative impact study (QIS) of the proposals, we urge the Basel Committee to further consult on a definitive path forward after finalising the new standardised approaches and after considering preliminary comments and the results of the QIS.

Order of the revision

We note that the Basel Committee has embarked on a thorough revision of the prudential standards for capital requirements. In the case of credit risk a new standardised approach with new indicators and metrics is being proposed. In addition, the prudential treatment of certain components, like securitisation, is currently subject to review. Other elements like Interest Rate Risk in the Banking Book (IRRBB) are also under consideration including the decision on whether it will also be addressed in Pillar 1 or only in Pillar 2. We also note that the guidance on the requirements for Total Loss Absorbing Capacity (TLAC), which is expected to have a considerable impact, has yet to be finalised.

Against this background, the EBF acknowledges that the old Basel I floor should be discontinued and we are of the opinion that a new scheme for capital floors should not be devised before a stable prudential framework is established. We are concerned that many of the new measures being considered are experimental including the parameters proposed for the new standardised approach. It is always difficult to assess the consequences of floors but it becomes even more challenging over a framework that is under construction. Consequently, we believe that setting up floors for the new framework should be the last step. We would recommend deferring the proposal for floors and reconsidering its appropriateness once the main components of the other reforms under way are decided.

Floors in the context of the current prudential framework

The proposal for capital requirements floors should be assessed against the background of the extremely safe post-crisis prudential landscape. The capital requirements have been strengthened in the Basel III framework and implementation should be fully completed, including the phase-in period, before the capital floors are considered. In fact, we note that the level of recapitalisation envisaged in 2009 has already been largely achieved. In this context, the need for floors should be carefully reconsidered.

Meaning and purpose of floors

The intention of the proposed framework is to replace the current transitional floor based on the Basel I standard. The original Basel I floor was intended to set out a gradual schedule towards the adoption of the risk sensitive models promoted by the Basel II standards. It was also meant to be temporary. However, the new capital floors framework has a completely different purpose because the proposed floor would be permanent and would not serve the same need of easing the transition towards a new standard. Instead, this set of floors is designed for other objectives and we provide our assessment of the ability of capital floors to meet these objectives below.

Objectives of the proposal

Whilst we agree with the objectives set by the Committee, we are sceptical about the use of floors to achieve those objectives, and we highlight some of our concerns below.

1. Ensure that the level of capital across the banking system does not fall below a certain level;

We think that the existing framework already includes the capacity to ensure that capital does not fall below appropriate levels. For instance, the leverage ratio and Pillar 2 are designed specifically for this purpose. The suite of policy tools available for supervisors is

sufficiently wide and varied to address any potential capital shortfall. In fact, the problem today is the sheer number of policy measures and the lack of transparency and understanding that such a complex set of rules brings about.

2. Mitigate model risk and measurement error stemming from internally modelled approaches;

We agree with the Committee that institutions' internal models as well as the Committee's Credit Risk IRB model to estimate total and unexpected loss contain model risk. However, we disagree with the Committee's solution that standardised approaches mitigate this risk. In fact, the Committee's standardised approaches are a different sort of model and contain, in our view, more model risk. The solution to reducing model risk is to enhance the standards and governance of all modelling, for which Pillar 2 currently offers supervisors plenty of possibilities.

We would like to draw the attention of the Committee to the fundamental review of the IRB approach that the European Banking Authority (EBA) is conducting. A set of regulatory products are to be released to achieve this objective. This fundamental review addresses discrepancies between IRB models that could stem from differences in definitions and modelling choices.

We think this is a best practice case showing the right way to account for and to reduce the model risk involved. The introduction of a capital floor framework could hamper this objective if the capital floor becomes binding because the comparison between IRB models will not reflect the pure differences between risk profiles.

3. Address incentive-compatibility issues; and

We do not think that the imposition of capital floors will achieve this objective. We believe that there are many other existing policies including the powers vested in competent authorities, Board oversight, and shareholder involvement that address the matter of incentives. We also believe that the IRB approach provides superior incentives that should not be overruled by the in most cases less risk sensitive revised standardised approach. We fear it could happen by implementing stringent floors based on the new standardised approach.

4. Enhance the comparability of capital outcomes across banks.

We think that the Committee is mistaken in seeking comparability through standardisation. The ambition should be to compare the true risk profile of institutions and not employ a floored metric that is limited and inevitably skewed.

Financial analysts, supervisors and other stakeholders typically use the various metrics available for different purposes in order to arrive at a holistic assessment of an institution. The combination of the following metrics makes the assessment or the comparison exercise complete: Risk Weighted Assets (RWA), Leverage Ratio, Total Loss Absorbing Capacity (TLAC), Stress Test results, benchmark studies, annual reports, quarterly statements, Pillar 3 disclosures and (for supervisors) the ICAAP & SREP information.

Adding a floor dimension could give an illusion of comparability but it will not enrich the understanding of stakeholders. On the contrary, floors would distort the meaning of some of the abovementioned measures.

Trade-off with other objectives

The abovementioned objectives impede to some extent other important objectives of the economies where banks operate. Concretely, the following aspects should also be assessed:

- The introduction of floors reduces risk sensitivity so long as the floors become binding. Distortions to risk sensitivity might give rise to market changes which impact should be estimated. One of them is the disincentive for the lowest risk portfolios and for exposures with safe risk mitigation instruments (e.g. covered bonds).
- Finance and growth is high in the policy agenda across the world. We think that the introduction of a floors framework could restrict banks' lending capacity when it is mostly needed.
- The impact should take this into account given that the current regulatory framework already includes a wide range of measures that make it safer and more reliable. Binding floors would only be needed if other more targeted policies had not been developed.
- Floors by risk type or by asset class would make the assessment of the bank risk profile more complicated. Bank managers and analysts would need to manage too many versions of the same reality. The use test would be unachievable.
- The unregulated sector would benefit from a floored banking sector and some risks would just shift to other corners of the financial system.

Capital floors to the detriment of low risk businesses

Flattened capital requirements resulting from the application of floors would hit first and foremost low risk banking businesses and, consequently, the availability and pricing of the associated banking services.

We would like to request specific examination during the impact analysis of two low risk assets which risk features, size and service to the economy deserve careful attention:

- Covered bonds, an asset class that counts with the safest risk profile including selective criteria of loans, recourse to the issuer banks and a preferential claim on the asset pool;
- Trade finance, mostly letters of credit and guarantees, short-term and uncommitted, which current treatment of low credit conversion factors and maturity should be maintained in view of its proven resilience.

In addition, we would urge the Committee to review the credit losses record of specialised lending, an asset class which risk profile is actually much lower than presumed. There is back-testing available, including a full economic cycle, for several categories of specialised lending, and in particular for commodity finance.

Pillar 2 and Pillar 3

The Basel II framework provided the basic elements, or 'pillars', for an improved prudential structure: risk sensitive statutory capital requirements (Pillar 1), supervisory review of the capital adequacy assessment, risk procedures and internal control (Pillar 2) and appropriate disclosure by each bank to allow for market discipline (Pillar 3).

The adoption of a complex set of floors based on a new standardised approach would override a large part of Pillars 2 and 3:



- Pillar 2 is intended to ensure that the capital of an institution is adequate, i.e. it does not fall under a minimum level, and it addresses this objective by using the right incentives. The supervisory review process is designed to ensure that the institution has appropriate risk controls in place and that it assesses other types of risk that the institution might be exposed to including model risk.
- Pillar 3 is meant to improve comparability, and it does so by promoting transparency and understanding. We note that Pillar 3 has not yet been developed to its full extent; we can expect a considerable improvement in comparability in the near future when Pillar 3 offers the benefits it was intended to produce.

In conclusion, the proposal for a framework based on floors represents a step back in the ambition to safeguard the right incentives in risk management and prudential supervision.

Regarding question 1 in the consultative paper

In response to question 1 of the consultative paper, the EBF favours policy measures that help improve proper risk management in banks. We think that the introduction of regulatory floors brings about confusion in the interpretation of risk information and could eventually remove incentives to the improvement of risk management practices.

Given that relevant characteristics of the proposal in the consultative paper are still undefined, we would not hazard a straight answer to the question on whether a floor should be established on an aggregate basis or at a more granular level. We could only assess the merits and drawbacks of different sorts of floors in the light of essential information including the final definition of the standardised approach metrics, its corresponding quantitative impact study (QIS) and the percentage of the floor.

In the absence of such information we can only indicate that an aggregate floor, *ceteris paribus*, is simpler than a multiple-layer floor.

We would like to insist on the need for a second round of refined proposals after the first QIS that could give us sufficient background information to assess this important question.

Floors over floors?

One of the major objections to introducing a whole framework of floors is the fact that the current regulatory framework already includes several floors with effects which are hard to measure.

Setting a floor for credit risk would change a figure already floored in the values of its underlying parameters, such as probability of default and loss given default. The final outcome could be very different from reality with no possibility to ascertain the result of pure risk modelling and to figure out the add-on of every sequential floor in the process of calculation of capital requirements.

Any remaining hope of maintaining the use test in place would be overridden by a complex set of floors over standardised approaches especially if applied at different and not aggregated levels.

Differences in the treatment of provisions

There is division of opinions as to the preferred option. Some members argue that option 1 is more theoretically accurate because it adjusts the capital at the appropriate tier. Other

think that option 2 is more pragmatic because it is simpler, more suitable and easier to understand.

Conclusion

The EBF acknowledges that the old Basel I floor should be discontinued and that it is pertinent to consider whether an alternative sort of floor should be put in place. For that purpose, it is important to consider the current prudential environment and all the targeted policies adopted since the start of the crisis. Against this background, it is important to keep the risk-based approaches and that the floor serves only as a backstop but not as a generally binding requirement since this would remove the incentives to use the internal models that better reflects the individual banks real portfolio and true risk.

We would urge the Basel Committee to assess the contribution of the capital floors framework to the objectives pursued as well as the consequences it might have on the achievement of wider economic objectives. There is need to strike a balance between banks' resilience and economic growth and much progress has already been realised in the former objective.

We would recommend that, if a floor is nevertheless to be introduced, the floor framework should be kept simple. For that purpose, an aggregate floor would allow an easier interpretation by all stakeholders and a less burdensome implementation.

Finally, we would urge the Basel Committee to calibrate the floor framework only after the new standardised approaches are defined to ensure a more accurate impact assessment.

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