

**Finance Watch response to the Basel Committee on Banking Supervision
Consultative Document “Reducing variation in credit risk-weighted assets:
constraints on the use of internal model approaches”**

Brussels, 24 June 2016

Finance Watch is an independent, non-profit public interest association dedicated to making finance work for society. It was created in June 2011 to be a citizen’s counterweight to the lobbying of the financial industry and conducts technical and policy advocacy in favour of financial regulations that will make finance serve society.

Its 70+ civil society members from around Europe include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs. To see a full list of members, please visit www.finance-watch.org.

Finance Watch was founded on the following principles: finance is essential for society and should serve the economy, it should not be conducted to the detriment of society, capital should be brought to productive use, the transfer of credit risk to society is unacceptable, and markets should be fair and transparent.

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General remarks

Finance Watch welcomes the initiative of the Basel Committee on Banking Supervision (BCBS) to conduct a comprehensive review of the Internal Ratings-Based (IRB) approach with a view to improving the comparability and reliability of internal models and reducing variations in Risk Weighted Assets (RWA), which are driven by bank practices.

We would like to reiterate, however, that incremental improvements of implementation rules are still unlikely to remedy the fundamental shortcomings of the risk-based capital adequacy framework under Basel II/III. Financial models are imperfect and whilst they might be a useful additional decision-making tool, they always operate under a finite set of assumptions, which will invariably be proven wrong at some point, sometimes to the extent of jeopardising the stability of the global financial system. Given the well-documented limitations of quantitative risk measures we believe that the marginal benefit of internal risk models for the purposes of risk management declines rapidly with the size and complexity of the models, in particular with the IRB approach. For the banks, however, the investment in these complex models tends to still pay off in the form of significantly lower capital requirements, a one-sided bargain in favour of the financial industry¹.

At present, banks enjoy a significant degree of freedom in the design of regulatory risk models, which allows them to arbitrage capital weights to reduce capital and expand leverage. Therefore, we welcome also the BCBS's aim to review the structure of the regulatory framework including considerations of the costs and benefits of basing regulatory capital on banks' internal models and alternative approaches to determining regulatory capital. Bearing in mind the shortcomings of internal models, arising mostly from model uncertainty, complexity and regulatory arbitrage, Finance Watch is convinced that the regulatory framework should not rely on them as a major Pillar 1 indicator of capital. The leverage ratio has been shown to be a much better predictor of banks' distance to default and should be considered a primary benchmark instead of a "supplementary measure"². Finance Watch intends to respond separately to the BCBS's ongoing consultation on revisions to the Basel III leverage ratio framework³.

¹ e.g. Mariathasan, Mike/Marrouche, Ouarda, The Manipulation of Basel Risk Weights: Evidence from 2007-10, University of Oxford, Department of Economics Discussion Paper No. 621, September 2012; (<http://www.economics.ox.ac.uk/materials/papers/12210/paper621.pdf>);

Le Leslé, Vanessa/Avramova, Sofiya, Revisiting Risk-Weighted Assets: Why Do RWAs Differ Across Countries and What Can Be Done About It?, IMF Working Paper WP 12/90, March 2012; (<https://www.imf.org/external/pubs/ft/wp/2012/wp1290.pdf>);

Blundell-Wignall, Adrian/Atkinson, Paul, The Subprime Crisis: Causal Distortions and Regulatory Reform, Conference Proceedings "Lessons from the Financial Turmoil of 2007 and 2008", Reserve Bank of Australia, Canberra, 14-15 July 2008; (www.rba.gov.au/PublicationsAndResearch/Conferences/2008/Blundell-Wignall_Atkinson.pdf), among others

² Blundell-Wignall, Adrian/Atkinson, Paul, Thinking Beyond Basel III: Necessary Solutions for Capital and Liquidity, OECD Journal: Financial Market Trends, Vol. 2010/1; (<http://www.oecd.org/finance/financial-markets/45314422.pdf>)

³ Basel Committee on Banking Supervision, Consultative Document: Revisions to the Basel III leverage ratio framework, April 2016; (<http://www.bis.org/bcbs/publ/d365.htm>)

Reduction of the scope for the application of IRB approaches for certain exposures

We welcome the BCBS's proposal to no longer permit the use of IRS approaches for certain exposures and agree with its underlying reasoning. Low-default exposures inherently produce few observations and are therefore likely to further exacerbate estimation errors. We note, however, that the consultation document does not currently propose a definition of low-default exposures, which would be highly desirable in order to set out a sound foundation for their regulatory treatment and would also lend itself to empirical testing.

Typically, sovereigns, public sector entities (PSEs) and multi-national development banks (MDBs) as well as large financial institutions (banks, insurance companies) and other corporates would be regarded as low-default exposures. Whereas sovereigns, PSEs and MDBs are classified as asset categories in their own right, no such classification exists to identify financial institutions and other corporates which would qualify as low-default exposures.

The BCBS proposal suggests that all banks and other financial institutions as well as corporate groups with consolidated assets in excess of EUR 50 bn should be subject to the standardised approach only and that corporate groups with consolidated assets in excess of EUR 200 mn should be removed from the Advanced IRB (A-IRB) approach. The proposal does not, however, provide any methodology or commentary on a) how these thresholds were derived and b) why exposures to corporate groups with consolidated revenues in excess of EUR 200 mn but with assets of EUR 50 bn or less would remain eligible for the Foundation IRB (F-IRB) (as opposed to the standardised) approach.

We believe that the treatment of large corporate exposures should not be considered in isolation but needs to be evaluated and regulated in the context of a more systematic and rigorous approach to the assessment of corporate credit risk in general. Practice-based divergences in the assessment of corporate portfolios are not limited to the low-default category of large corporates but extend across the entire spectrum. In its recent RCAP on RWA variation in Retail and SME exposures⁴, the BCBS identifies once again a significant dispersion of outcomes in respect of risk weights and, consequently, regulatory capital calculations for the SME asset class of corporate exposures. Even if there are, to some extent, different and specific reasons for the observed variations there is clearly a recurring concern that banks' calculations of risk factors for all classes of corporate exposures under the A-IRB approach give rise to unwarranted and unjustified variation. In view of the already excessive complexity of the Basel II/III risk modelling framework the regulatory response should be simple and consistent.

Finance Watch would recommend using the Basel II definition of the SME exposure class (par. 273)⁵ as a point of departure for the consistent categorisation of corporate exposures. Corporate groups that do not qualify as SMEs under that definition would be classified as large corporates and should be considered *a priori* as low-default exposures. We refer in this context

⁴ Basel Committee on Banking Supervision, Regulatory Consistency Assessment Programme (RCAP): Analysis of risk-weighted assets for credit risk in the banking book, April 2016;
(<http://www.bis.org/bcbs/publ/d363.htm>)

⁵ i.e. reported sales for the consolidated group are less than €50 million

to the March 2015 Discussion Paper published by the EBA⁶. For financial institutions the criteria for low-default exposures should be defined separately, based on metrics that are appropriate for the financial sector.

Subject to the above we agree that exposures to large financial institutions and corporates, as well as equities held in the banking book, are potentially well suited to be moved to the standardised approach. We appreciate that the treatment of sovereign exposures, PSEs and MDBs is not within the scope of this consultation and are looking forward to a comprehensive proposal by the BCBS on this subject.

We also support the proposed revisions of the Credit Valuation Adjustment (CVA) and Counterparty Credit Risk (CCR) frameworks, with the reservation that, in the interest of transparency and consistency, the application of the Internal Model Method (IMM-CRR) should be restricted. We would also note at this point that reliance of VaR modelling for regulatory risk assessment purposes should be discouraged in view of its inherent flaws, which have been exposed in the course of the financial crisis⁷. Instead, all counterparty credit risk exposures should be calculated under the standardised approach (SA-CCR).

F-IRB and A-IRB – Time for a cost-benefit assessment?

The introduction of IRB approaches as part of the Basel II framework has marked the beginning of a costly and often disruptive modelling “arms race” among banks. Ten years later many of the criticisms levelled at the IRB framework in the wake of the financial crisis of 2007/08 still appear to be valid and RWA variability continues to be a major concern. Whereas some of this variation may be explained, e.g. by country-specific or cyclical factors, practice-based divergences are still substantial and attributable to a number of material issues related to the calculation of virtually all IRB input factors, i.e. Probability of Default (PD), Loss Given Default (LGD) and Exposure At Default (EAD).

We note, in particular, that (downturn) LGDs are flagged, time and again, as one of the main sources of variability: in the BCBS’s 2013 RCAP on low-default exposures⁸, LGD is identified as a significant source of cross-bank differences in RWAs under the A-IRB approach. In its 2016 RCAP on SME and Retail exposures⁹, the BCBS observes that bank downturn LGD and EAD estimates tend to diverge widely from actual loss observations with banks facing numerous challenges including the availability and standardisation of loss and exposure data and different methods of modelling recovery rates. In view of these difficulties, even A-IRB banks frequently use uniform LGD rates for certain asset categories, i.e. in practice apply a form of modified F-IRB approach.

⁶ European Banking Authority, Discussion Paper: Future of the IRB Approach (EBA/DP/2015/01), 04 March 2015, pg. 49; (<https://www.eba.europa.eu/regulation-and-policy/credit-risk/discussion-paper-on-the-future-of-the-irb-approach>)

⁷ Taleb, Nassim N., Statement to the U.S. House of Representatives, Committee on Science and Technology – Subcommittee on Investigations and Oversight, The Risks of Financial Modeling: VaR and the Economic Meltdown, Hearing, 10 September 2009 (Serial No. 111–48), Washington, Government Printing Office, 2009; (<https://www.gpo.gov/fdsys/pkg/CHRG-111hhrg51925/pdf/CHRG-111hhrg51925.pdf>)

⁸ Basel Committee on Banking Supervision, Regulatory Consistency Assessment Programme (RCAP): Analysis of risk-weighted assets for credit risk in the banking book, July 2013; (<https://www.bis.org/publ/bcbs256.htm>)

⁹ see Footnote 4

Against this background it would appear justified to ask whether the purported benefits of the A-IRB approach, i.e. a more accurate and granular capturing of individual banks' risk profile, have materialised in practice and whether they are commensurate in any way to the incremental costs, in terms of implementation costs and supervisory effort, vis à vis the F-IRB approach, in particular. We would therefore welcome a cost-benefit assessment of the need for the current dual-track IRB framework. If, as it appears, banks are able to obtain the benefits of adopting A-IRB, i.e. a significant reduction of capital requirements¹⁰, without the attendant benefits for the general public and the financial markets, i.e. more accurate risk management, which contributes to financial stability, the underlying bargain is flawed and should be reviewed as a matter of urgency.

Finance Watch welcomes the BCBS's initiative to reduce the variability of RWA outcomes by restricting the number of parameters banks can model under the IRB approaches. We believe, however, that this initiative should be taken further, in the interest of removing excessive complexity and restoring a level playing field between IRB and non-IRB banks, by converging F-IRB and A-IRB into a single IRB standard in due course. This converged approach should be based largely on the standardised and F-IRB approaches, with only a selected number of meaningful asset classes available for IRB modelling and a significantly reduced number of modelling parameters. These parameters should, in turn, be subject to regulatory benchmarks and floors: whereas banks' modelling outputs could deviate from the regulatory benchmarks, banks should be called upon to justify these deviations to their regulator with reference to the specifics of their business model and exposure profile, rather than modelling choices. Floors should be set in line with the respective standardised approach metrics.

Exposure-level model-parameter floors and IRB parameter estimation practices

Finance Watch supports the BCBS's baseline proposal for IRB parameter floors and its clarification on the range of permissible practice for estimating certain parameters, subject to our general remarks set out above.

In connection with the proposed method for calculating LGD_s for exposures secured by eligible financial collateral under the F-IRB (sec. 4.2.2.) we would, however, call upon the BCBS to reconsider the 0% LGD floor. The experience of Autumn 2008 has shown that even large and liquid segments of the capital markets can come close to a standstill as a result of a systemic shock. If financial assets held as collateral are put on the market under these circumstances they, too, may be sold only at "fire sale" discounts. In the absence of a prudential capital charge any loss realised would rapidly erode the bank's regulatory capital. It would appear prudent therefore to review the treatment of these exposures and consider the need for applying a commensurate haircut to the collateral.

We would also like to express our concern about the potentially unintended impact of the proposed readjustment of haircuts and LGD for exposures secured by eligible non-financial collateral under the F-IRB. Whereas we agree in principle with the argument that realised values in periods of stress are often significantly lower than the carrying value, and overcollateralisation should therefore be increased accordingly, we note that a standard haircut of 50%, equivalent to 200% overcollateralisation, could be excessive and may reduce the availability of credit to certain categories of borrowers. To balance these considerations with

¹⁰ see Footnote 8, pg. 22-23

the BCBS's objective of a more conservative valuation of non-financial collateral we would prefer to see lower haircuts (40-45%) combined with higher LGDs (25-30%).

We do not agree with the proposed removal of the minimum collateralisation requirement. On the one hand, the realisation of non-financial, in particular physical, collateral is inherently different in terms of granularity and transaction costs. A difference in treatment to financial collateral is therefore warranted. On the other hand, markets for physical collateral are almost always less liquid and hence more likely to seize up during stressed periods. There is therefore a comparatively higher probability that non-financial collateral may not be realisable at all in a downturn. We would therefore suggest that a minimum collateral threshold be maintained.

In the case of modelling the impact of collateral taken against unsecured exposures under A-IRB (sec. 4.2.5) the BCBS suggests that banks should be allowed to continue modelling the unsecured downturn LGD (LGD_U) term of the weighed-average F-IRB formula. We believe that this approach would once again reduce comparability, and introduce another potential opportunity for RWA optimisation where banks could effectively opt for the method, F-IRB or A-IRB, which produces the more favourable outcome. We would suggest that in cases where the bank cannot readily account for the impact of collateral in its A-IRB the F-IRB approach should be applied without the exception.

In respect of the proposed amendments to the Credit Risk Mitigation (CRM) framework (sec. 4.5), we would like to reiterate our reservations against the acceptance of VaR modelling for the purposes of regulatory risk assessment. The shortcomings of this methodology have been discussed extensively in the wake of the 2007/08 crisis: its failure to account for low-probability / high-impact risks has been identified as a main cause for the global spread and magnitude of the crisis. Moreover VaR modelling is known for distorting incentives for market participants and encouraging excessive leverage¹¹. The removal of VaR for calculating exposures subject to counterparty risk for securities financing transactions from the standardised approach is an appropriate response to this experience and we would therefore suggest to remove it from the IRB approaches as well.

Other issues

In the context of improving consistency between the different approaches permissible under Basel III, the BCBS raises the question whether banks should continue to be allowed to choose different approaches (Standardised, IRB) for different asset classes. This practice, most obvious in the permanent partial use of the Standardised approach for sovereign exposures by IRB banks, is one of the more egregious examples of regulatory arbitrage and has been commented upon by the BCBS on several occasions¹². As mentioned previously, Finance Watch strongly support measures which improve the comparability of credit risk assessments and restore a level playing field between banking groups that apply different risk-weighting approaches.

¹¹ see Footnote 7

¹² e.g. Hannoun, Hervé, Sovereign risk in bank regulation and supervision: Where do we stand?, Speech at the Financial Stability Institute High-Level Meeting (Abu Dhabi, UAE), 26 October 2011; (<http://www.bis.org/publ/bppdf/bispap72y.pdf>); Basel Committee on Banking Supervision, Regulatory Consistency Assessment Programme (RCAP): Assessment of Basel III regulations – European Union, December 2014; (<http://www.bis.org/bcbs/publ/d300.pdf>)

If one of the primary objectives of offering the option of an internal-ratings-based approach is to provide an incentive to banks to introduce more sophisticated risk management systems and practices it surely cannot have been the intention to selectively promote such systems and practices in respect of individual balance sheet items, chosen at the bank's convenience. It also contradicts the very essence of the IRB approach, which is to provide a more accurate and granular representation of risk. It would therefore be highly desirable, in our view, if banks opting for the IRB approach were obliged to apply this method for all asset classes where it is available.