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FRENCH BANKING FEDERATION RESPONSE TO BCBS's CONSULTATION ON CAPITAL FLOORS

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

I. General comments

The FBF welcomes the opportunity to respond to the Basel Committee's consultation on capital floors.

Basel 3 has reshaped the banking sector while making it more resilient. Banks are currently putting unprecedented substantial efforts in order to continue implementing this framework. With the new metrics added on top of the risk-based capital ratio, liquidity ratios and a leverage ratio, each provided with a specific objective, the new Basel framework will efficiently ensure that the goal of financial stability is reached.

European banks are convinced that a risk-based capital regime should remain at the core of the regulatory framework. Risk sensitivity is essential and internal models remain the best available method for reflecting the true risk of a bank's actual portfolio of exposures. The risk-based capital regime is complemented by safeguards such as the leverage ratio, as a back-stop, as well as regulatory stress testing and benchmarking. As a result, internal models allow determining risks in an accurate manner; they are well integrated within banks starting from capital metrics computation across to the business level as required by the use test provision.

We believe that by reinstating a capital floor based on standardised approaches as a permanent framework, the Basel Committee is putting into question the role of internal models. The proposed set-up will rather be interpreted as a sign that the regulator no longer believes in the IRBA framework, thereby increasing lack of market confidence in RWA.

The internal models framework has proven its value as a risk sensitive way of measuring capital requirements. The high degree of flexibility within the internal models framework may have to some extent compromised comparability in capital requirements. We are therefore fully aligned with the EBA's approach, which has been to work since 2012 on increasing comparability across models by setting out binding standards for further improvements and clarifications in the regulatory framework. Concomitantly, Eurozone banks involved in the Single Supervisory Mechanism are getting ready for the announced re-approval process of all their internal models by the European Central Bank, as of 2015 and over a period of three years. As a result, by 2018 the IRB models of European banks will be deeply reshaped in terms of their robustness and comparability of RWA calculations.

We understand the capital floors consultation is intimately linked to the one on the review of the standardised approach currently being consulted on and the forthcoming one on the IRB approach review. However, through the BCBS's "Reducing excessive variability in banks' regulatory capital ratios: A report to the G20" (published last November) we understand that the Committee will finalize its review of the standardised approach on credit risk and floors by end-2015. We strongly encourage the BCBS to finalize its comprehensive review of the entire Basel III framework (credit risk, market risk, operational risk and securitisation) before introducing a new permanent capital floor, while continuing to engage with the industry on these important regulatory developments.

Capital floors and the leverage ratio

In the consultative document, the introduction of the capital floor is considered to be an integral part of the capital framework under Basel III and should promote confidence in the regulatory capital framework. It is seen as a complementary approach to the leverage ratio. Our view is that the various objectives (please refer to Table 1 in the consultation paper) to be addressed by the introduction of a capital floor **are either already addressed via the introduction of the leverage ratio or can be reached by alternative, generally simpler means**. We would like to draw the Committee's attention on the following:

- **RWA inconsistency and dispersion:** This issue refers to the fact that different banks assign a different weighting to the same underlying exposure. Within a certain range, this practice is normal and can be explained by different assumptions within banks respective models. The essence of Basel III text is to encourage banks to have a strong knowledge of their counterparties which leads in practice to a precise and tailor-made amount of capital covering the risks. We agree that the range of the resulting risk weighting cannot be unlimited, but we believe that the EBA's and the ECB's initiatives highlighted above will lead to a satisfactory handling of this dispersion, without any need to rely on standardized measures which are too often not driven by risk considerations or will (and can) not take into account risk considerations in a satisfactory manner. A floor would reduce the risk-sensitivity of regulatory capital, as the standardised approach is much less risk-sensitive than the IRB one. The higher the floor level, the more risk-sensitivity will be lost. The need for a floor is not justified by an illustration that credit risk models have generally failed: further back-testing should be encouraged instead.

- **Low levels of models-based RWAs:** The financial crisis showed that the banks' lending activity to corporates, for example, performed remarkably well even during a period of extreme stress. Back-testing of Basel parameters (including probability of default, but also credit conversion factors and loss given defaults) shows that the vast majority of the assumptions calibrated pre-crisis was confirmed. We are not convinced that RWAs are overall significantly too low and we believe that model risk is adequately dealt with by the introduction of the leverage ratio.
- **Horizontal inequity in risk-weighted capital:** It is indeed true that banks using the standardised approach have to set aside a higher amount of capital than banks using the IRB framework –the underlying incentive being that banks develop their risk management systems and practices. We therefore believe that some discrepancy between standard approach banks and IRB banks is not detrimental. Moreover and as highlighted above, there are initiatives underway to reduce this gap.
- **Increased IT costs :** Assuming the capital floor will be based on the standardised approach, this means that IRB banks will have to calculate capital using three completely different approaches
 - Capital needs based on the IRB frameworks ;
 - Capital needs based on the Standardised approach (to which a floor would be applied) ;
 - Capital needs based on the leverage ratio.

As a result, as many parameters needed for the Standard approach are currently not relevant for IRB banks and therefore not systematically available in their IT systems, we expect a significant increase in IT system investments for IRB banks.

- **Increased management complexity:** The introduction of Capital floors based on standardised RWA would have a significant impact on the capital allocation process, as it is neither purely driven by risk, nor purely driven by business volumes. In practice, in addition to the balance sheet size constraint resulting from the leverage ratio, banks **would have to allocate their capital based on two totally different calculations**, i.e.
 - capital needs based on the IRB framework ;
 - capital needs based on the Standard approach (to which a floor would be applied).
- **Unexpected deterioration in the quality of the credit portfolio:** Moving away from a risk-sensitive regulatory capital approach through the imposition of a floor will provide the wrong incentives: increasing regulatory capital on transactions benefitting from careful structuring and risk mitigants will decrease their profitability, reversing the efforts made since the introduction of Basel II. Holding riskier assets will become more attractive, particularly if they help reduce the overall impact of the floor.
- **Increased disintermediation:** banks will have a significant incentive to sell / distribute / syndicate their low-default/high standard weighting portfolios to unregulated third parties.

To sum up, we are not convinced that a systematic Pillar I floor would be helpful in increasing confidence into Basel III regulation. Given that the proposed capital floor may be perceived as a lack of endorsement by the Committee of internal models:

- We strongly encourage the BCBS to finalize its comprehensive review of the entire Basel III framework (credit risk, market risk, operational risk and securitisation) before introducing a new permanent capital floor;
- Upon completion of this comprehensive review, and if considered as unavoidable based on a subsequent QIS, we suggest introducing a global floor into the Pillar 2 framework in order to address potential outstanding outliers issues.

Please find our responses to the consultation's questions below.

II. Answer to questions related to the consultation

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?

As the proposals for new standardised approaches do not demonstrate at this stage their capacity to be more risk sensitive than an external rating approach (cf. FBF's answers to the Committee's consultations related to market risk, operational risk and credit risks standardised approaches), the new Capital Floor should be viewed as a backstop measure and not a Pillar 1 driver; the capital floor as currently proposed may otherwise have undesirable effects. Indeed a capital floor based on non-discriminating risk drivers would ultimately favour riskiest businesses which generate higher margins.

As previously argued, the proposed approach is not yet calibrated, we are therefore strongly in favour of an aggregate RWA-based floor considered within the Pillar 2 framework.

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?

Context

The measurement of provisions against expected losses is meaningful for capital assessment purposes. According to Basel III, if the combination of specific and general provisions is less than expected losses, additional capital is potentially needed as the difference must be deducted from CET1. Under the IRB approach, if the combination exceeds expected losses, the treatment is more conservative—only general provisions subject to a certain threshold can be added to Tier 2 capital, as this portion is not linked to any identified losses and can be more readily available. The additions to Tier 2 capital are subject to 0.6% of RWAs under the IRB approach.

Options

The consultative paper provides 2 options for adjusting for differences in provisioning as part of floor calculations. It is worth noting that these options are proposed in the context of currently applicable accounting rules (IAS 39) and with no visibility on floor calibration and its calculation basis, as RWA under the Standardised Approach are currently under review.

Choosing one option over the other in this context may therefore be challenging as banks may not have sufficient information to assess the consequences and the mechanics of the calculations are not sufficiently detailed in the consultation paper.

In addition, the Basel Committee has indicated it will revisit the EL shortfall/excess computation in view of the changes in the impairment regime for regulatory capital standards (see BCBS's consultative document on "Guidance on accounting for expected credit losses"). This may influence the preference of one option over another.

Overall, Option 1 seems to present the following features:

- Its rationale reflects the approach currently used by banks, hence may be simpler to implement
- It allows distinguishing between provisioning adjustments made to CET1 and Tier 2 capital
- It may be more advantageous for a bank with an EL shortfall (i.e. insufficient provisioning).

As far as Option 2 is concerned:

- It will affect all three capital ratios (CET1, Tier 1 and Tier 2), making it difficult to implement for banks
- It may have a negative impact on capital and RWA for a bank with an EL shortfall (i.e. insufficient provisioning).

Conclusion

Bearing in mind all the unknowns and the circumstances highlighted above, we would support Option 1 under the current prudential and accounting framework.

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

No comment.