



Comments

on BCBS Consultation Paper "Capital floors: the design of a framework based on standardised approaches" (BCBS 306)

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The German Banking Industry Committee is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent approximately 1.700 banks.

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I. General comments

The Basel Committee on Banking Supervision would like to replace the currently applicable lower limit for the banks' capital resources according to which the capital requirement is a minimum of 80 per cent of the requirements under Basel I (so-called Basel I Floor). In the future, this floor shall apply to the capital requirements in accordance with the standardised approaches (which are currently under revision). According to this, the capital requirements shall be at least a certain percentage of the capital requirements under the standardised approaches. It is not yet clear whether the floor shall apply to the entire bank, the individual risk types or exposure classes.

The consultation paper is of substantial fundamental importance to the further development of the Pillar I regulation of the Basel Committee. The aim is to take into account model risks, improve the comparability of the capital requirements and reduce the effects of the variability of the model results on the capital requirements. This is to counteract distortion of competition.

We support these objectives. However, we entertain grave doubts as to whether these objectives can be achieved by means of the broad introduction of floors on the basis of standardised approaches, i.e. whether the Basel Committee is taking the right path. The basic deficits of the standardised approaches such as

- the lower risk sensitivity that reduces, and not improves, the comparability of the results;
- the overemphasis and underemphasis of risks due to sweeping supervision models – standardised approaches are also models within this meaning – which cannot appropriately reflect individual portfolio structures and cannot, or not adequately, cover the diversification and hedging effects; and
- the danger of gaming (the possibility of playing off the standardised approaches, e.g. due to insufficient capture of basis risks)

will continue to exist even after the Basel reforms of the standardised approaches for market, credit and operational risks. Accordingly, we believe that standardised approaches are not suitable to serve as a floor for model-based capital requirements and, therefore, object to the introduction of such a lower limit.

As the Basel Committee's Standards Implementation Group (SIG) has demonstrated for the trading book, the differences between the banks' capital requirements are to a very large extent due to different supervisory requirements or to admissible differences in the application of these requirements by the banks.¹ We believe that to reduce these differences the banking supervisory requirements should be addressed. One focus should be the standardisation of the banking supervisory requirements regarding approval and the ongoing supervisory review of internal procedures.

¹ Basel Committee on Banking Supervision (2013): Regulatory consistency assessment programme (RCAP) – Analysis of risk weighted assets for market risk, Basel.

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With respect to this, the European Banking Authority already has presented a Draft Regulatory Technical Standard (RTS) on the harmonisation of the approval and reviewing practice in the EU² regarding the IRBA. Moreover, it may be helpful to limit the scope of supervisory discretion with respect to the application of the internal procedures. In this regard as well, important decisions to set the course have been taken in the EU by the intention to introduce uniform banking supervision regulations ("Single Rulebook").

However, sufficient leeway should remain for the banks to apply different internal procedures. This would enable them to check - within the framework provided by supervision - different procedures in competition which would promote the continuous improvement and development of these procedures. Moreover, excessive standardisation might lead to the banks behaving uniformly in a stress situation (herd behaviour). This entails risks for the stability of the financial markets and should, therefore, from a banking supervisory point of view, be weighed up against the advantages of a higher level of standardisation. Not least, excessive standardisation of internal procedures might make them unusable for internal risk control. Since the banks are required to use procedures approved by the supervisory authorities also internally, this would be a clear incentive for not using internal procedures.

Considerable negative incentive effects might result depending on the design of the floor regulations. In addition, there is a danger that the use of the internal models for the calculation of capital requirements might become unattractive. This would be the case in particular if introduction or maintenance of internal models were no longer associated with a capital incentive, or associated with an insufficient capital incentive, also for the purpose of the calculation of the capital requirements. Recognition of internal procedures for the measurement of the equity capital requirements meant incentives for the banks to use advanced risk measurement methods. These incentives were based not only on the expectation that these procedures were associated with an improvement of risk management. They were also based on the hope that the use of these procedures overall will result in lower prudential capital requirements. Actually, the Basel Committee on Banking Supervision had emphasised calibrating the capital requirements in the aggregate in such a way that the use of internal models is rewarded.

At the same time, the introduction of the planned floors also leads to misguided control. It is in the nature of the thing that standardised approaches reflect the banks' risks in a less "granular" way than internal procedures. Moreover, it has to be assumed that standardised approaches will capture the specific risks of the individual banks with less detail than internal procedures. Another weak point of the credit risk standardised approach (in particular when compared to the advanced IRBA) is the limited consideration of securities. Also, the capital requirements determined by means of standardised approaches react less quickly to a change of an item's risk. For example, in the context of the IRBA, the ratings have to be adjusted whenever the bank has new information about a counterparty. Especially now that the banks have gathered sufficient historical data that also includes a financial crisis, internal rating methods should be particularly able to precisely determine the banks' risks.

² European Banking Authority (2014): Draft Regulatory Technical Standards – On the specification of the assessment methodology for competent authorities regarding compliance of an institution with the requirements to use the IRB Approach in accordance with Articles 144(2), 173 (3) and 180 (3)(b) of Regulation (EU) No 575/2013

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The effects described above ultimately result in the risks being overestimated in some cases, and underestimated in others. In addition to this, diversification effects and the effects of hedging are covered just insufficiently (if at all).

On the other hand, the additional calculation of the capital requirements in accordance with the standardised approaches, which would be necessary for checking the floor, would cause substantial additional expenditure at the banks.

As a result, the objectives mentioned above may be missed, but the negative side effects may occur. We, therefore, believe that floors are not a reasonable measure to achieve the objectives. We will explain this in more detail below.

The statements below regarding the individual sections of the consultation paper must be seen against the background of this basic criticism.

A final assessment of the Basel Committee's proposal is difficult and, ultimately, impossible, in particular due to the missing level of detail regarding calibration.

Although we emphatically object to application of the standardised approaches as a floor for the capital requirement, we would like to point out that in case such a floor should be introduced, strong incentives for using the internal procedures should remain. Accordingly, the floor should be just a percentage of the equity capital requirements in accordance with the standardised approach which should be as low as possible. The time schedule for publishing the paper, including final method and calibration, at the end of 2015 appears to be extremely ambitious. It is doubtful whether final calibration makes sense given the regulatory topics that are still outstanding (revision of the credit risk standardised approach, standardised approach for counterparty risks, standardised approach for the operational risk, interest rate risks in the banking book etc.), but also against the background of the model approaches. Overlapping with topics such as MREL and TLAC should also be taken into account. Furthermore, we point out that substantial sunk costs would be generated if the "existing" standardised approaches were to be implemented for the calculation of the floor requirements for a few years before the "new" standardised approaches were introduced.

We, therefore, suggest that the time schedule for the introduction of the floor be harmonised with the time schedule for the introduction of the standardised approaches and other relevant regulatory initiatives. In particular, we find it is indispensable to calibrate the floor only once all standardised approaches have been finalised, to enable full consideration of the interdependencies. Moreover, we expect a consultation with respect to the calibration of the floor and would very much welcome it if another consultation phase were granted before the final standard is published. The time of coming into force of the new credit risk standardised approach requirements should also be included in the consultation.

From our point of view, it should, moreover, be examined in more detail what impact economic cycle phases have on the calibration of the floor. Especially in connection with the new standardised approaches, any possible cyclic effects are otherwise difficult to estimate.

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II. Specific comments (paragraphs 11 – 27)

Objectives (paragraphs 11 - 12)

With respect to an analysis of the individual objectives of a broad floor regulation across all risk categories, it has to be questioned in particular whether the objective can be achieved at all by means of a floor regulation (effectiveness) and whether there are alternative, better ways to achieve the objective (efficiency).

Objective 1: Preventing undue optimism in bank modelling practices, thereby ensuring that modelled capital requirements do not fall below a prudent level (also paragraph 13: Low level of model-based RWA)

Obviously, a floor regulation is to prevent underemphasis of risks on the basis of internal models to ensure that the capital requirements do not fall below a prudent level. It is questionable whether such a level exists at all and how it is to be determined. A "correct" risk level, and hence an appropriate capital requirement, cannot be determined without doubt, least of all on the basis of standardised approaches. These standardised approaches have themselves the character of a model and can overemphasise, but also underemphasise, risks. Consequently, a floor, derived from standardised approaches, would be either too high or too low. Supervisors are by no means better "model builders" than the banks themselves, as demonstrated by all proposals regarding standardised approaches which have been published so far. We, therefore, emphatically warn against regarding standardised approaches as prudential benchmarks and putting trust in them without critically calling their weaknesses into question. Ultimately, a floor regulation is not effective.

Objective 2: Mitigating model risk due to such factors as incorrect model specification, measurement error, data limitations and structural changes that may not be captured in historical data

Model risks of internal models are not adequately addressed by supervisory models (standardised approaches have the character of a model) which are themselves subject to model risks (see also our comments above regarding Objective 1). A floor is not an effective measure.

Instead, the validation efforts which are most likely suitable to reduce model risks should rather be stepped up in the context of a comprehensive validation approach. This first of all involves quantitative approaches such as backtesting, validation of the input parameters, benchmarking (not on the basis of standardised approaches but on the basis of cross-comparisons between banks with identical risk profiles) and analyses of the robustness and sensitivity of the model estimates and, secondly, qualitative validations that likewise include important verification approaches.

Under the IRBA, model risks are understood as the danger that the criteria chosen fail to create a sufficient differentiation, or even provide a wrong differentiation, of the borrowers. The resulting incorrect assignment of value judgements regarding credit quality might then lead to unexpectedly

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high losses and hence to capital below a prudential level. Actually, there are already clear specifications for the consideration of model risks in Pillar I in the form of inaccuracies of estimates to be expected due to insufficient data or not wholly satisfactory methods. In that case, the parameter estimates have to be adjusted in a conservative manner (adding of a margin of conservatism). This is required for example by many national supervisory authorities for the so-called low-default portfolios for the PD estimate. Also in the case of lack of data for LGD estimates, conservative adjustments have to be made frequently. With that, model risks are also included in the capital requirements. Moreover, the regulations of European regulatory law provide for regular auditing by the supervisory authority and for annual assessments by internal audit departments and external public auditing companies. In addition, annual validation ensures that deficiencies as to selectivity result in adaptation measures. It is true also for modelling faults as well that as the duration of application and the size of the application portfolio increase, liability to faults decreases. Once comprehensive application experience has been gathered, relevant model risks no longer exist.

With the IRBA, measurement risks can lead to distortion in two places: (i) With respect to default detection and (ii) with respect to the calibration of risk classification methods:

Re (i): Firstly, defaults in the bank's credit processes may be overlooked. How high this risk is to be rated primarily depends on how long a bank already has been approved for the IRBA, because in the context of approval, the functioning of the default detection processes is confirmed by the supervisory authority and subsequently reviewed and ensured consistently by additional suitability checks and check-ups. The same goes for the annual audits by the internal audit department and external public auditing companies. Moreover, it is checked on a regular basis in the context of the annual validation, which itself is the object of the aforementioned internal and external audits, that the default processes meet the regulatory requirements. Insofar, a constantly declining risk of measuring errors in default detection results from an increasingly longer term of IRBA approval. Additional security is, moreover, provided if as many customers as possible have to be handled in the process, as this entails routine and accuracy.

Re (ii): In the context of the calibration of rating methods, the long-term average default quota plays a special part. It is used to translate the scores of a risk differentiation procedure into a probability of default. The interrelationships described above mean that the quality of the long-term default quota increases the longer IRB systems have been used. However, the quota not only contains fewer faults as regards the measurement of individual defaults, but above all also a reduced risk as regards its appropriateness for a portfolio. The reason for this is that after a certain time of application the quota is no longer subject to distortion caused by market cycles. In other words, the long-term default quota is no longer dependent on the current phase of a cycle, because it reflects the mean value over an entire cycle. Supervision in the context of the IRBA set of rules takes account of this for example by the fact that the required extent of so-called margins of conservatism is reduced continuously as the number of observations and years of observation increases.

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For trading activities as well, there already are strict capital requirements under Pillar I that also address model risks, namely in the area of "prudent valuation". Here, additional valuation adjustments (AVAs) are determined for the balance sheet valuation of fair-value instruments, which have to be deducted from the CET1. In the process, a buffer is also created for model risks of valuation models at the instrument level. In this way, valuation risks resulting from the existence of competing valuation models and from model calibration are addressed by an EBA standard. The required adjustments for market price uncertainties as well can be interpreted as model risks.

Objective 3: Addressing incentive compatibility issues, as banks face incentives to use overly optimistic internal models to reduce risk-weighted assets and thereby maximise return on equity

The incentives described above actually exist and can basically be addressed by means of a floor regulation. However, it is the supervisory authority's own responsibility to counteract such incentives in the context of its audits of the internal models. In the auditing practice, this is already taken into account comprehensively, for example by the margins of conservatism described above or by capital deductions. In this respect, there is no need for an additional floor.

Objective 4: Improving comparability by providing a standardised assessment of risk which can be compared against internal model-based outcomes

As explained (Objective 1), we must be cautioned against believing that standardised approaches deliver better risk estimates than internal models – the opposite is true due to the deficiencies of the standardised approaches specified in section "General comments". There can be no "one-size-fits-all standard risk measurement". As standardised approaches cannot be tailored to a bank's individual portfolio structure, the risk estimate is imprecise, because risks are not, or not adequately, appreciated. The result may be both underestimation and overestimation of risks. Hence, comparisons between model results and standardised approaches will usually only bring to light the deficiencies of the standardised approaches.

Objective 5: Constraining variation in model-derived risk-weighted assets (RWAs) that arises from differences in bank and supervisory practices, thereby improving the comparability of RWAs across banks and over time. (also: paragraph 13: RWA inconsistency and dispersion)

Model variations occur in either direction, whereas floors only take account of one direction of deviation and hence are not sufficient tools for reducing differences with respect to the capital requirements. Moreover, floors do not reduce the result variability itself, but merely its effects in downward direction on the height of the capital requirements. Thus, a floor is not effective.

A substantially more reasonable measure for reducing – not eliminating – the result variability is to look for reasonable possibilities for reducing the degrees of freedom of internal modelling and hence also for reducing the complexity of the modelling. There definitely are possibilities of standardisation here, which we are very willing to discuss in detail with the Basel Committee.

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However, such efforts must not lead to uniform internal standard models, as they cause banks to act in the same way (herd behaviour). Diversity of the models is desirable from a banking supervision point of view, because it causes reduced cyclicality of the capital requirements. Associated with this is the fact that we have to live with a certain degree of variability, as also stated by Mr Ingves (Basel Committee).³

Objective 6 (paragraph 13): Horizontal inequity in risk-weighted capital requirements

We cannot comprehend the reasoning, because it only takes account of capital-related costs. A level playing field between standardised approach and model banks will be achieved only if transition to the model approach means capital savings. This results from the substantial additional costs that model banks need to incur for Pillar-I-conforming implementation, including initial validation, the implementation, in particular, of organisational minimum requirements that necessitate higher human resources deployment, the model approval examinations (incl. check-ups) and the measures for maintaining the model approval such as validations of or changes to models.

Relation between capital floors and leverage ratios (paragraphs 13 - 15)

Likewise, the arguments why a leverage ratio should be necessary even in addition to complement floor regulations are not convincing. In principle, we continue to be very critical of the leverage ratio as well as a regulatory tool, because of the often described negative side effects. Apparently, the Basel Committee is now also acknowledging the very limited insolvency prediction capability of the leverage ratio. For example, it is very noteworthy that in the context of the reform of the credit risk standardised approach the CET1 coefficient, and not the leverage ratio, is suggested as indicator for the creditworthiness assessment of banks.

Use of low RWA to boost financial leverage

Incorrectly specified risk weights (e.g. the zero-weighting of certain government bonds) are not an argument in favour of a leverage ratio which does not fight the root cause of the faultiness, but only in favour of a reform of the risk-based standardised approaches.

Unexpected large losses in low-RWA portfolios

Irrespective of whether a portfolio is a low, medium or high RWA portfolio, such losses, if they actually occur, are likewise indicative of the need for a reform of the respective RWA determination and are not an argument in favour of a leverage ratio.

³ Keynote address by Mr Stefan Ingves, Governor of the Sveriges Riksbank and Chairman of the Basel Committee on Banking Supervision, at the Ninth High Level Meeting for the Middle East & North Africa Region, jointly organised by the Basel Committee on Banking Supervision, the Financial Stability Institute and the Arab Monetary Fund (AMF), Abu Dhabi, United Arab Emirates, 18 November 2013.

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Lack of market confidence in RWAs

This approach to justifying the leverage ratio as well does not address the root causes of the sometimes missing confidence in RWAs, whether determined based on model results or standardised approach. In this respect, measures that, in particular, address the internal models make more sense and are more promising, e.g. by means of improved transparency, comprehensive model validation approaches, reasonable standardisation to reduce the variability of the model results, a strengthening of the use concept and the consideration of model risks.

Design – Calibration (paragraph 16)

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

Unfortunately, the consultation paper does not contain general deliberations as to the calibration of the floors, save for the information that the floor is to be calibrated as a percentage of the respective standardised approach. However, fundamental reflections regarding the design of the floors cannot ignore this issue, because cross-cutting reflections can be made in this respect as well.

Depending on the (potentially wrong) calibration of the floor regulation, considerable negative incentive effects might be created:

On the one hand, we see the **"danger of gaming"**. The following effect might occur when the floor applies, i.e. the risk estimates of the internal model are clearly below the floor level: The bank might take higher risks according to the model risk measurement, without the standardised approach showing higher risks, e.g. through basis risks in the market risk area not taken into account in the standardised approach. This would not have an effect on the capital requirements until the floor is reached. Therefore, the choice of the floor level is of critical importance to the design of the floor regulations. This effect is to be expected in particular in the case of overemphasis of the risk under the standardised approaches which still is to be expected, in connection with the definition of a too high floor.

Moreover, an **incentive** should be **maintained** to use internal models also for Pillar-I purposes to promote, and not impede, the further development of bank-internal risk measurement and management systems. Reasonable regulatory incentives such as the introduction of the IRBA under Basel II have led to clear progress at the banks with respect to the quality of quantitative credit risk measurement and credit risk control. Disciplining, and hence improvement in terms of data collection and data quality, has also contributed to clear progress in risk management. The close coupling, or the consonance, between internal control and determination of the capital requirements is a valuable achievement which should not be abandoned.

To counteract both of the two negative incentives mentioned, the floor must be clearly less than 100% of the standardised approach (calibration on the basis of the model results).

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Design – Level of aggregation (paragraphs 17 - 19)

RWA floor or capital floor (paragraph 17)

Basically, there are two options to define a floor. The first option is an RWA floor, i.e. the RWAs determined on a model basis are compared to the RWA based on X% of the standardised approach and the higher value must be used. The second option is a capital floor which checks whether the banks also meet the capital requirements which may be increased due to the floor, without the RWAs themselves being limited to a floor. The consultation paper does not make clear which design is favoured. We advocate a capital floor design.

Aggregation of risk categories (paragraphs 18 - 19)

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?

In our opinion, a floor across risk types is the best of the variants presented. Its advantage is that it is easier to understand for investors and other stakeholders. From our point of view, this would not be the case for floor regulations per risk type or exposure class, due to the clearly higher complexity. In connection with this, we point to the intention of the Basel Committee to design the regulations regarding capital requirements in a risk-oriented fashion, but also in a simple and easy-to-understand fashion (BCBS 258⁴). Moreover, the floor across risk classes is the solution most similar to the existing concept of the Basel I floor, which improves understandability and reduces the implementation expenditure to be expected.

Apart from this, we see a danger that in connection with the IRBA, a floor based on risk category would be an incentive to utilise creative leeway with respect to exposure class assignment. Additional challenges result from the fact that, at the moment, credit risk standardised and IRB approach exposure classes are not congruent and that substitute securities can cause shifts within the exposure classes. From an implementation and control perspective, we point out that in a group of companies the calculation of a floor at the exposure class level results in high complexity. Since at a higher number of floors the probability that the floor applies is clearly higher, the assessment of transactions, or group units, may, from a capital lockup perspective, become much more difficult.

In this regard, we also point to the difficulty to demand the same capital level in case the calibration is universally valid for all three variants shown. For example, if you take a bank A with capital requirements in an IRB exposure class X clearly below the floor requirements and in another IRB exposure class Y clearly above the floor requirements, but overall, across all exposure classes, with capital requirements just slightly below the floor requirements, bank A will have to keep higher capital requirements than bank B which has its corresponding capital requirements "evenly

⁴ Basel Committee on Banking Supervision (July 2013): Discussion paper - The regulatory framework: balancing risk sensitivity, simplicity and comparability

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spread" to the two exposure classes. As a consequence, individual calibration would be required for both banks to achieve identical results in the example.

In addition, the example shows that possibly bank A has no incentive to improve its risk measurement for exposure class X.

Therefore, from our point of view, a floor across risk types is a reasonable balance between economic incentive and regulatory control. It gives banks a reasonable incentive to continue to measure risks precisely and optimise portfolio quality, but at the same time it is ensured that a certain capital level is maintained at all times on the basis of the standardised approach.

Design – Adjustments for differences in treatment of provisions (paragraphs 20 - 24)

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?

We believe that both variants of calculation of the shortfall (between the provisions for risks on the balance sheet risk provisioning and the expected loss determined under banking supervision regulations) are associated with challenges:

Option 1, in which the regulatory capital basis is adjusted, can in our opinion not be calculated at the exposure classes level, because this would require that the capital basis be assigned to individual exposure classes. This would lead to additional complexity in this variant.

Another complex factor is the calculation of the floor on the basis of all capital ratios, because different capital components are taken into account for each capital class under both the IRB and the credit risk standardised approach. We believe it is debatable whether even more adjustments should be made to the capital definitions which already are highly complex. Moreover, from our point of view, the question arises whether, when adjusting the CET1 due to the shortfall, the appropriate subsequent threshold value deductions (deferred tax assets, investments in financial sector entities) are to be taken into account and adjusted.

Since, in addition to this, the regulatory capital basis forms the basis for other regulatory indicators as well, it should also be borne in mind that an adjustment of the capital would, for example, require an adjustment of the leverage ratio.

Option 2 at first glance seems to be somewhat more intuitive, but we believe a crucial weak point is that capital components taken into account in the tier 2 capital are taken account of in the RWAs in the same way as capital components taken into account in the tier 1 capital. A result of this may be that banks, on the one hand, want to avoid general loan loss provisions or, on the other, the reporting of an excess between provisions and expected losses.

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Choice of the standardised approach (paragraphs 25 - 26)

We favour a selection of the floor in accordance with the regulations of the appropriate jurisdiction.

Disclosure (paragraph 27)

No comments.