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By email: baselcommittee@bis.org

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Dear Sirs

Consultation Document on Capital Floors: the design of a framework based on standardised approaches (December 2014)

HKAB welcomes the opportunity to respond to the Basel Committee on Banking Supervision's ('the Committee') consultation paper 'Capital floors: the design of a framework based on standardised approaches'.

We share the Committee's view that the current Basel I capital floor should be reviewed. The Basel I floor was originally a temporary safety measure to ensure capitalisation levels would remain appropriate upon transition to Basel 2. Since then, a number of additions to the regulatory regime have been implemented, resulting in the Basel I floor becoming increasingly dislocated from the capital levels now required. However, we do not agree that capital floors are necessarily an integral component of the capital framework and have significant concerns with the introduction of a capital floor based on the standardised approaches. The imposition of floors would neither reduce complexity nor aid comparability. While there may be a possible role for floors on very low default data portfolios, they should not be used permanently to rectify perceived weaknesses in the underlying theory of risk-weighting itself, particularly the basis of the regulatory risk-weight for certain assets like residential mortgages and financial institutions. We are also of the view that a number of the perceived shortcomings outlined in the consultation could be addressed through existing methods within the capital framework more quickly and in a manner more easily explained.

Chairman The Hongkong and Shanghai Banking Corporation Ltd
Vice Chairmen Bank of China (Hong Kong) Ltd
Standard Chartered Bank (Hong Kong) Ltd
Secretary Henry Chan

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秘書 陳崇禧



While we agree with many of the Committee's objectives, we believe that the case for the continuation of a capital floor has not yet been proven. In many cases, the objectives are already addressed by other components of the prudential regime, such as the leverage ratio, additional capital buffers and the stress-testing regimes. Furthermore, regulatory initiatives aimed at reducing RWA variance and improving comparability are either underway or are forthcoming. Where shortcomings continue to be present, these should be addressed directly within the internal model approaches directly or through adjustments in existing regulatory tools, rather than via a capital floor.

It is also necessary to ensure that there remain positive incentives for continuous improvement in risk sensitivity and accuracy of the modelled approaches, and this is not eroded through the use of a capital floor. We also consider that the proposed regime may result in a downward shift in risk profiles of banks thus stifling credit to low risk exposures and constraining market making activity.

The proposed linkage of standardised approach based with internal model based capital requirements will inevitably establish standardised approach based capital requirements as the true capital requirement. This would undermine the objective to have a meaningful differentiation of risk and the ultimate goal of improving risk-sensitivity.

We support the Committee's objective of improving comparability between banks; however we do not believe that this will be achieved through a standardised floor, due to the number of national discretions within the revised standardised approaches which will consequently be embedded into a capital floor.

Given the level of regulatory change currently underway, would urge the Committee to defer the decision on the need for a capital floor and its calibration until the many moving parts in the new regime have settled and a thorough and appropriately timed Quantitative Impact Study ('QIS') has been completed.

We have summarised our key comments below and provide further detail, with answers to the specific questions raised in the consultation, in the appendix to this letter.

Questionable basis for implementation of a new capital floor and alternative proposal

We do not believe that sufficient causal links can be drawn between the perceived issues outlined in the consultation and the introduction of a capital floor based on standardised approaches. A significant amount of the professed shortcomings outlined in paragraph 13 of the consultation exist as a result of the design of the relevant approaches. Internally modelled approaches, by the nature of their design, increase the variation and horizontal inequality in RWAs and, while some of this could be deemed excessive in certain cases, it is important to note that a significant amount of this is reasonable, accurate and desired.

All the shortcomings outlined in paragraph 13 of the consultation are not only questionable, but are also solvable using existing measures at the disposal of regulators. If the shortcomings outlined are to be accepted, it is still unclear why the most appropriate resolution is through a capital floor. It would seem a more logical starting point to revisit the internally modelled approaches with a view to imposing improved, or even stricter requirements where deemed necessary.

As identified in the consultation paper, many of the model risk issues identified as objectives of the regime have already been addressed through the leverage ratio. We consider that the additional perceived shortcomings outlined in the consultation are already being addressed through other new supervisory tools at the disposal of regulators. These tools include:

- the use of stress testing as an essential tool in capital planning and providing further insight and challenge into modelled risks;
- enhanced capital requirements through the use of capital buffers;
- the use of macroeconomic tools such as sectoral capital requirements and portfolio floors e.g. use of LGD floors, already serve to address variability and reinforce the risk weighted framework;
- recently finalised Pillar 3 disclosure requirements which will significantly increase granularity and standardisation of disclosures and seek to enhance and improve comparability and transparency of internal modelled RWAs;
- Pillar 2 assessment to deal with aspects of model related risk, such as credit concentrations; and
- supervisory review processes intended to interrogate internal models to improve model integrity and credibility, thereby addressing any assumed incentive-compatibility issues.

Any shortcomings in these existing methodologies should be addressed directly in improvements in internal approaches, or via adjustments in existing regulatory tools rather through the application of a floor. For example, a more logical starting point would be to revisit the internally modelled approaches, with a view to introducing improved requirements where deemed necessary. In conjunction, supervisory processes should be enhanced to ensure that implementation by institutions is in line with these minimum requirements. The introduction of capital floors before these reforms are completed, not only undermines on-going work to improve internal models, but also undermines the objectives discussed in this consultation paper.

While we agree that the current level of variability may be undesirable, it is important to note that some variance is reasonable, accurate and to be expected as a natural product of differing business models, risk appetite, portfolio diversification, and

internal risk management and governance.

In addition, we believe it is possible to achieve significant improvements in the determination of risk-weighted assets while also delivering simultaneous improvements in risk-sensitivity and comparability without establishing capital floors based on standardised approaches via:

- Eliminating unwarranted differences in definitions and methodologies, and whether imposed by supervisors or chosen by banks, arbitrary conservative restrictions on models. This will reduce a significant component of current differences;
- Enhanced disclosure, which could include the use of risk-sensitive benchmarks and hypothetical portfolio exercises. This will enable the market and regulators to scrutinise residual differences and discuss them with the banks;
- Improvements to the mathematical approaches (e.g. adopting more appropriate risk curves and pooling of data for low default approaches). This will improve risk-sensitivity.

Furthermore, other concerns, such as macro-prudential considerations or more general the level of capitalisation, should be dealt with through minimum capital requirements and buffers.

Inappropriate use of standardised approaches as the basis for a capital floor

We do not support the standardised approaches as an appropriate basis for the calculation of a capital floor, as it prioritises an inferior approach over the superior internally modelled approaches. The outputs of these approaches when rigorously developed, more accurately reflect risk, and while they are not immune to error, they remain superior to standardised risk weights. In comparison the standardised approaches are blunter and are designed to ensure banks that are unable to accurately calculate internally modelled parameters, apply a consistent and prudent approach to capital allocation.

In addition, in recent years the International Financial Reporting Standards are moving to place more importance and reliance on internal risk parameter models to determine the appropriate level of provisioning. Implementing the proposed capital floors based on standardised approaches would move the capital regime backwards and enshrine these approaches as the true capital requirements. It might even widen the gap between accounting and prudential standards.

With that background institutions would be disincentivised to continue to invest in internally modelled approaches for capital purposes. This would result in a break in the linkages between risk management and capital, which would be wholly detrimental, and would result in capital requirements not being reflective of underlying risk. In addition there is a real possibility of adversely affecting institutions use of models, shifting the focus from modelling in the most appropriate manner, to prioritising modelling efforts that will allow for a desired impact of any capital floor. This may actually have the effect of detracting from model quality where internally

modelled approaches remain in place and hiding any associated impact.

Comparability

The use of standardised approaches will not solve comparability issues. The divergent national implementation inherent within the standardised approaches will be embedded into a capital floor as noted in the Committee's Regulatory Consistency Assessment Programme, meaning comparability across jurisdictions will not be achieved. International organisations would be required to operate multiple floors for solo and consolidated reporting even before calibration of the capital floor is itself, considered. Perceived lack of comparability is therefore not resolved but simply moved to a different part of the capital framework and embedded into its design.

Calibration

The consultation does not cover the associated calibration of the capital floor, which makes comprehensive review of its design difficult. We believe that the assumption that calibrating at the aggregate level and at the risk-based level in such a way as to keep effects on capital entirely neutral, is unachievable across different institutions.

Variations in the dispersion of exposures and RWAs across different organisations will lead to the calibration of aggregate floors and risk category floors having dramatically different outcomes, often with minimal changes in actual risk. Appreciating that the Committee will have to calibrate to an appropriate norm, individual institutions cannot simply discount the effects on them when reviewing the design of the floor.

We would highlight that if the Committee intends to finalise calibration by the end of 2015, this is likely to be in advance of the transposition and implementation of the underlying standardised approaches, therefore it is unclear how meaningful calibration is possible within these timescales.

A calibration determined using approximations and without the actual transposition of the revised standards into national law, would be significantly less defensible than the internally modelled approaches the floor is supposed to be superseding in the capital framework.

We would recommend that calibration is determined after the standardised approaches have been transposed into national law and impacts of the revisions can be assessed. At which point it would be highly beneficial for detail of the calibration methodology to be made transparent.

Disclosure requirements

The consultation makes minimal comment on the disclosure requirements that will complement the floor. Without this information it is difficult to comment on whether the Committee's goal of increased comparability would be met.



The inference from paragraphs 22 and 27 of the consultation is that the output will be shown as a cap on capital ratios i.e. capital ratios will be disclosed on a before and after basis. Where the capital floor is binding, a reduction in the capital ratio will require extensive explanation with disclosures. In particular, a simple disclosure will tell investors little about the varying concentrations of counterparty type, industry lending or products which are far more likely to impact the actual capital ratio than a ratio which is bound by a capital floor. As such the introduction of the proposed framework would require banks to establish significant volumes of additional disclosure that in effect does not provide the analyst community with additional insight on banks' risk profile. Rather than explaining the true risk profile, banks will be required to reconcile the capital requirements under both approaches. Such reconciliation will have to focus on conceptual and methodological differences, while distracting the reader from changes in the underlying risk profile.

Furthermore, it will be important to understand the extent to which the floored capital ratio will interact with other requirements such as disclosed Pillar 2 requirements.

It is therefore important that the Committee clarifies these disclosure requirements as soon as possible.

Implementation

The implementation of this proposed floor regime for banks utilising internally modelled approaches is a considerable undertaking and will require significant lead times to make changes reporting systems and processes. Given the far-reaching consequences of the revision to the standardised approaches and the capital floor, a more systematic and suitably phased finalisation of requirements and subsequent implementation would seem appropriate.

We hope you find our comments useful. For any questions, please do not hesitate to contact Ms Emily Ngan of the Secretariat at (852) 2526 6080.

Yours faithfully

A handwritten signature in black ink, appearing to be "H Chan", written in a cursive style.

Henry Chan
Secretary

Enc.

c.c. Ms Karen Kemp, Executive Director (Banking Policy), Hong Kong
Monetary Authority

Appendix I – Capital floors: the design of a framework based on standardised approaches: Responses to the specific questions

Q01: 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?

We do not believe that a capital floor based on the standardised approaches constitutes an enhancement of the capital framework. However, if the Committee selects to implement this, the floor based upon the aggregate across risk types (which is in line with the current approach that has already been well recognized by the industry) would appear to be preferable in the absence of further information. Adopting such could minimize the efforts and the associated costs in implementing the new capital floor framework in the future, although disclosure requirements are unclear that an aggregate floor would be more explicable and provide easier comparability across organisations and against Pillar 2 capital buffers.

We note however, that the decoupling of calibration from this question and the assumption that effects would be capital neutral is conceptually unsound. Variations in the dispersion of exposures and RWAs across different organisations will lead to the effect of aggregate floors and risk-level floors being dramatically different; this cannot simply be discounted when designing the floor.

It is important that a further consultation on calibration is undertaken, once the revised standardised approaches have been finalised. This should include a dedicated QIS, which would allow us to provide an informed view on the impact and preference of a floor based on risk categories or on an aggregate basis.

For the option of setting capital floor based on exposure class, we believe it may lead to complicated calculation where there may likely need to have significant system change to facilitate the identification. In addition , an exposure class floor is unlikely to provide direct comparison, due to inconsistent definitions of exposure classes. Exposure class floors are synonymous with sectoral capital requirements and there are a number of asset class floors, already embedded within the existing framework. Furthermore, a more granular application would significantly increase the required disclosure without adding insight on a banks' risk profile. Hence we do not prefer adopting that as base for capital floor setting.

Q02: 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 do not believe that a capital floor based on the standardised approaches constitutes an enhancement of the capital framework. However, if the Committee proceeds to implementation, further detail will be necessary on the options provided. The stylised examples provided are too simplistic and do not allow for a full assessment of their impacts, this results in a number of questions which need to be addressed before we

are able to provide an informed view, in particular,:

- the examples do not currently take into account circumstances where expected losses exceed provisioning;
- the examples provided also assume a bank has general provisions as a key line item to adjust for, however under IAS 39 credit risk provisions would be considered specific provisions rather than classified as general provisions eligible as own funds Tier 2.
- it will also be necessary to consider any impact resulting from the future application of IFRS 9;
- the examples do not take into consideration, the proposed difference in design of the capital floor – i.e. risk category floor versus aggregate floor;
- under both options, it is unclear in circumstances where the capital floor is a binding constraint, whether adjustments to either capital resources or the RWA calculation would be required for other regulatory requirements e.g. for the purposes of large exposures, RWA requirements for TLAC purposes etc; and,
- Option 2 assumes a RWA conversion ratio of 1250%, which does not take into account banks' effective capital requirements which are in practice significantly higher than 8%.

Q03: Do you have any other comments regarding the design of the capital floor?

We do not see any compelling reasons for adopting a capital floor, particularly based upon standardised approaches which are inferior to internally modelled approaches in terms of risk sensitivity and scrutiny/calibration to its design. If the Committee continues to implement a floor based on the standardised approaches, an aggregate floor is the preferable design of the options provided.

The design of the framework for capital floors should recognize the potential risk of duplication with capital buffer under Pillar 2 without adding risk-sensitivity, while creating additional complexity. In order to allow for a level playing field, capital floors should be consistently calibrated, i.e. there should be no allowance for national discretion (to avoid a situation similar to capital buffers as introduced under Basel III). Floors should be set at a level that retains an incentive for firms to implement and to advance modelled approaches.