

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland
baselcommittee@bis.org

27th March 2015

Dear Sir/Madam:

Re: *Capital Floors: the design of a framework based on standardised approaches*

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

The IBFed supports the use of models for prudential requirement purposes and is committed to collaborating on the current international policy initiatives to reduce model variability and to enhance the comparability of capital metrics across banks. Several studies are available at global and local levels, including from industry associations and authorities. These initiatives seek to achieve a higher degree of transparency and consistency whilst keeping much of the benefit that models have to offer, notably in terms of meaningful risk information. This is a major objective that should be put before the use of capital floors.

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. 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 considering preliminary comments and the results of the current and future QIS on the various risk-weighting frameworks that are currently being revised.

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 be addressed in Pillar 1 or 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, we are of the opinion that a new scheme for capital floors should only be devised, if required, once 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 using 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 requirement 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 capital floors are considered. In fact, we note that the level of recapitalisation envisaged in 2009 has already been largely achieved¹. We also note that the Basel III leverage ratio already provides an effective and relatively straightforward capital floor. 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 floor framework has a completely different purpose because the proposed floor would be permanent and would not serve the same purpose 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 the countercyclical

¹ Basel III Monitoring Report (March 2015) at <http://www.bis.org/bcbs/publ/d312.pdf>

capital buffers 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 overlapping between 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 which is part of Pillar 2.

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.

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, 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 and impacts 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). The consequences that floors could have on those portfolios should be assessed specifically including the potential shift to other instruments.
- Finance and growth is high in the policy agenda across the world. The Committee should take this policy agenda into account and consider the impact of its proposal 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 have 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.

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.

In conclusion, we believe 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.

An aggregate floor

In response to question 1 of the consultative paper, the IBFed 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 improve 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 multi-layered floor.

We strongly urge that a second round of refined proposals be issued after the first QIS to provide us with 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 which have effects that are hard to measure.

Setting a floor for credit risk would change the capital requirements which are based on the values of the 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 based on standardised approaches, especially if applied at different and not aggregated levels.

Differences in the treatment of provisions

There is a diversity of opinion as to the preferred option. Some members argue that option 1 is more theoretically accurate because it adjusts the capital at the appropriate tier. Others think that option 2 is more pragmatic because it is simpler, more suitable and easier to understand.

Conclusion

The IBFed acknowledges that the old Basel I floor should be discontinued and that it is pertinent to consider whether an alternative type 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. Floors based on the new Standardised Approach should only be considered once they have been calibrated and fully implemented.

Against this background, we would urge the Basel Committee to reassess 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. Much progress has already been realised in the former objective and we would argue that additional floors would be redundant given the many policy reforms already in place.

If an additional floor framework is put in place, we would recommend keeping it simple. For that purpose, an aggregate floor would allow an easier interpretation by all stakeholders and a less burdensome implementation. Moreover, it is important that the floor serves only as a backstop but not as a generally binding constraint.

Finally, we would recommend that the floor be calibrated only when the new standardised approach is finalized to ensure an accurate impact assessment.

We thank you for taking our comments into consideration, and we look forward to future discussions on these issues.

Yours sincerely,

A handwritten signature in black ink, reading "Sally Scutt". The signature is fluid and cursive, with the first name "Sally" and the last name "Scutt" clearly legible.

Mrs Sally Scutt
Managing Director
IBFed

A handwritten signature in blue ink, reading "Deborah H. Crossman". The signature is written in a cursive style, with the first name "Deborah" and the last name "Crossman" clearly legible.

Debbie Crossman
Acting Chair
IBFed Prudential Supervision Group