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Re: Basel Committee on Banking Supervision Consultative Document: Revisions to the Standardised Approach for credit risk, December 2014.

Dear Sir/Madam,

We appreciate the opportunity to share our views on the Basel Committee on Banking Supervision Consultative Document on Revisions to the Standardised Approach for credit risk. On behalf of the scholars in International College of Renmin University and some professionals in banks, we would like to present several comments and hope they would be useful for furthering development of the revision standards.

The revised framework of standardized approach for credit risk provides an alternative risk assessment approach and reduces the reliance on external rating assessments, which, we believe, would strengthen the standards of capital for credit risk and benefit the upgrade of credit risk management in the banks implying standardized approach. Under the revised standardized approach, capital adequacy ratio and indicators based on financial information are chosen to replace external credit ratings as risk drivers, which obviously would increase risk sensitivity and accuracy in capital calculation. From the perspective of risk assessment and measurement, the revised approach could encourage banks implying standardized approach to pay more attention to the analysis of credit risk exposures and therefore would definitely benefit these banks' risk management.

We support most of the proposals to the standardized approach for credit risk. However, we notice that the revision does not consider the differences on the capital issues between advanced markets and emerging markets. For the banks in advanced markets, the main capital problem is that banks are undercapitalized and the calculation of capital is inaccurate, especially under the development of financial innovations. Since the revision to Basel Accord in 1990s, the changes of standards have mainly focused on increasing capital adequacy or improving the capital calculation accuracy by introducing more risk factors, strengthening the quality of capital and its capacity to absorb losses, and increasing the risk sensitivity of regulatory capital. For this most recent revision, one of the most important objectives is to reduce variability, and it basically focuses on increasing risk sensitivity and improving the accuracy of capital calculation, and we think the revision would be necessary and effective in solving the capital problems of the banks in advanced markets.

However, for the banks in emerging markets, like those in China, the capital issues are more complicated. These banks face the problems not only about capital adequacy and calculation accuracy, but about the functions of capital in promoting financial stability, from both ex ante and post ante perspectives of risk management. The capital issues in emerging markets are obviously different from those in advanced markets. In China, considering the transitional nature of the economy and the primary stage of market development, bank capital to some extent is supported by government credit. In additional, the mechanism of capital to improve banks' governance and risk management is still under development, and compared with the banks in advanced markets, the framework of ex ante risk management of the banks in China still needs further development. Thus, simply increasing the adequacy of capital amount and accuracy of capital calculation is not sufficient to solve the crucial capital problems in China, and it is vital to develop the functions of capital in improving governance and risk management, and to build up the mechanism of capital-based ex ante risk management, which would effectively provide incentives for banks to develop enterprise-wide risk management framework and ultimately contribute to financial stability of the entire system.

We understand that the core objective of Basel Accord is to increase safety and resilience of banking system by proposing the risk-based minimum capital requirement, and the spirit of Basel Accord is to improve banks' risk management through capital requirement, which contributes to financial stability. From such respect, capital adequacy in its amount should not be the ultimate objective. Especially from the perspective of risk management, the effects of capital adequacy on financial stability mostly reflect in absorbing losses, and the effectiveness is limited as is seen in the subprime crisis; while ex ante enterprise-wide risk management system, which is influenced by capital charge, is more crucial to financial stability due to its ex ante nature and proactive effect. Thus, the banks in emerging markets, like those in China, should promote the functions of capital in ex ante risk management.

Based on the views presented above, we would like to make following suggestions:
1. We suggest that more fundamental concepts and approaches of modern risk measurement and portfolio management should be introduced to the framework, not simply increase the comparability of basic concepts and capital requirement with IRB approaches. We notice that the revision introduces some financial indicators, such as revenues and leverage ratio, more directly reflect the riskiness of exposures and reduce the reliance on external rating, which undoubtedly could encourage banks to enhance business risk analysis. However, compared with IRB approaches using internal risk measurement, the revised standardized approach is still based on the traditional financial analysis, so it probably could not provide sufficient incentives for banks to imply modern risk measurement techniques; furthermore, its effects to the establishment of modern risk management, such as credit portfolio management, risk adjusted return on capital and etc., are limited. In China, since most banks are only eligible to imply standardized approach, and they hardly can be capable to imply IRB in short time, the revised framework might not be sufficient to motivate these banks to develop modern risk management and thus could not help to solve the capital problems as described above.

2. We suggest the Committee introduce preferential capital equivalent deduction or preferential regulatory coefficient based on banks' credit risk management improvement, to increase the incentives for banks using standardized approach to enhance risk management. Banks can save capital by using IRB approaches, which provides banks the incentive to apply modern risk management methods and techniques, and therefore the banks' improvement on applying advanced risk management can be viewed as part of eligible capital. But for most of the banks using standardized approach that are unable to transit to IRB approaches in short time, the revised framework does not provide them any alternative way to save capital. Under such situation, these banks do not have incentives to establish the modern risk management.

3. Besides the suggestions we made above, we also hope the Committee could reconsider the risk drivers of bank exposure. Firstly, using CET1 ratio as a risk driver for bank exposures would possibly cause circular reference problem. Secondly, using Net NPA ratio as the measure of asset quality may have problems on accuracy, since the standards of calculation and disclosure of Net NPA ratio are not sufficient and clear in long time; the ratio is easily manipulated by banks, which would possibly lead to variability in calculation of capital requirement.

We hope our comments above could be useful to the future development of the standards. Thanks for your time.

Sincerely,

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