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Basel Committee on Banking
Supervision

Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches

Key message

- The Swedish Bankers' Association supports the overall intent to reduce excessive variability in risk-weights, while keeping the risk sensitivity in the regulatory framework.
- The primary way forward should be further development of the IRB approach through harmonising methods and practices for parameter estimation rather than reverting to non-risk sensitive standardised risk weights. For instance, the EBA standards and work undertaken to align default definitions, PD computation, treatment of defaulted assets as well as downturn LGD, is a significant step in the right direction, i.e. contributing to comparability, reducing complexity and maintaining risk sensitivity.
- The overarching goal should be to keep the IRB approach for all portfolios where banks can produce reliable parameter estimates meeting uniform and meaningful minimum criteria for estimation.
- For low default portfolios, data pooling is a solution that should be carefully evaluated by the committee.
- Output floors, even if calibrated at the lowest level indicated by the BCBS, will become the binding constraint for banks with a large portion of low risk assets, reducing the incentive to keep those assets on the balance sheet.
- Output floors may also have an adverse effect on the incentive to further develop the methodology for assessment and pricing of risks.

General comments

The Swedish Bankers' Association supports the overall objective, to improve internal models in order to maintain risk sensitivity in credit assessments. We are of the opinion that a risk-based approach building on internal models shall be the basis for determining capital requirements, also in the future. Risk sensitivity is essential and internal models remain imperative in building awareness and understanding risks both within banks and among supervisors. Internal models are also the best method for reflecting the risk of a bank's portfolio of exposures and characteristics, and therefore allocating adequate levels of capital to protect the banking system against these risks.

We believe that refining the internal ratings-based (IRB) approach is a far more fruitful method to achieve the Basel Committee's objective, to reduce variation in risk weighted assets, than to prohibit the IRB-approach or limit the use of A-IRB for the exposures in scope of the consultation. It would be more appropriate to increase the level of harmonisation for internal methods, both for A-IRB and F-IRB, than to address the issue of comparability through e.g. introducing output floors. We are of the opinion that excessive variability in risk weights should be addressed through more harmonised parameter estimation practices. We observe several concrete initiatives in the European Union, e.g. the draft RTS on Definition of default developed by the European Banking Authority (EBA), that can be used as a basis for these harmonisation activities.

Since the implementation of Basel II banks have become increasingly adept in properly measuring their risk and using that knowledge in the day-to-day business. Increasing the focus on common and predefined minimum capital adequacy output values and parameter levels would constitute a set-back in the work towards prudent risk measurement, as it turns focus away from modelling and reduces the need for future development of IRB models. Maintained focus on IRB methodology, development and practices would instead benefit oversight and call the attention to banks' real risk characteristics.

Floors on input values as well as output values create a supervisory fixed risk sensitivity that deviates from banks' risk profiles and the built in risk sensitivity functions in the various IRB models. As supervisors also have divergent perceptions of risk resulting in different scaling of the add-ons, such measures could severely hamper comparability and transparency across countries.

Scope of use of internal models

The Swedish Bankers' Association is of the opinion that the differentiation of corporates based on size in terms of assets and revenues is arbitrary and not a good reflection of risk. The Basel Committee considers, in the consultation paper, banks

and large corporates to be low-default exposures. Portfolios with low default frequencies, however, are generally regarded as lower risk than portfolios with high default frequencies. As a consequence we find it hard to see any convincing arguments why exposures to banks and large corporates should be subject to a less risk sensitive standardised approach, which is expected to yield significantly higher capital requirements than the modified IRB approaches. The latter is especially the case for exposures to investment grade and unrated corporates. In Sweden and the Nordic countries it is not very common that corporates have an external rating, therefore the exposure will be treated as unrated and with a disproportionately high risk weight.

We understand that there might be tail-risk concerns associated with an unforeseen default of a bank or a large corporate. To the extent that this is a concern, we believe this is better dealt with under the large exposures framework, since this concern relates more to the size of the exposure to the defaulting counterparty, rather than the size of the counterparty itself.

That said we recognise that banks' internal models should continue to be enhanced with a view of reducing variability in risk weights for comparable portfolios. We agree with the view of the Basel Committee that it is challenging to obtain reliable estimates of LGDs and also CCFs for low default portfolios. Our view is however that it is possible to obtain reliable estimates of PDs even for low-default portfolios. Our view is further that there are robust and generally accepted modelling techniques capable of validating PD. Further, in this context, the proposed treatment of large corporates with consolidated assets greater than EUR 50bn does not seem to reflect the fact that there are more public disclosures available for these counterparties than others. In other words banks should be better able to perform a deeper assessment of creditworthiness of these counterparties.

For portfolios where banks are unable to produce reliable LGD and CCF estimates we acknowledge that the use of F-IRB parameters would be appropriate. Banks should thus be allowed to use the maturity factor of the A-IRB. For other portfolios banks should be allowed to use the A-IRB approach in full. Data pooling should be promoted as one way to achieve enough data for parameter estimation.

We are of the opinion, regarding the proposal to restrict the use of A-IRB models for certain corporate exposures, that any changes to the A-IRB should be thoroughly analysed by the regulators and the industry and carefully evaluated before going forward with rigorous changes. Also, the cliff effects, mentioned by the Committee, are in themselves an argument for not going forward with the proposals.

Furthermore, we question the rationale for the suggested limits between A-IRB and F-IRB. Total revenues do not necessarily correspond with risk. Rather, it is the kind

of business model and industry which the company operates in that determines the risk level of the obligor. We would instead advocate the limit to be based on the number of default or loss observations available for estimation, in order to obtain table parameter estimates that adequately reflect the underlying risk.

Parameter floors

In general we understand the goal of the Basel Committee to reduce variation in credit risk-weighted assets. The aim to reduce variability must, however, not work to the detriment of the objective of preserving prudent risk assessment models in large banks. E.g. exposure level parameter floors significantly reduces the risk sensitivity of the IRB-approach.

We are of the opinion that the Basel Committee's proposal needs to be enhanced with a thorough analysis on how models could be altered to lessen the scope for variation of the outcome, instead of primarily resorting to floors and thresholds. The proposed corporate LGD floor is not explained or justified as it stands and the potential impact of this is as yet unclear.

While the Basel Committee continues to work to adjust the IRB methodology to cater for a higher degree of comparability between banks, input floors could be used as a temporary solution. Temporary floors would give ample time to develop and implement future harmonization efforts. The Basel Committee should in that case state in the final paper that the temporary floors will be removed in e.g. 5-10 years.

Furthermore, the proposal does not contain any justification for not differentiating between commercial and residential real estate, neither simplification that would make these resulting risk parameters unreliable as measures of banks' actual risks. The lower riskiness of residential real estate compared to commercial real estate is recognised in the current regulatory framework and in the proposed new standardised method and should also be reflected in the parameter floors to maintain some degree of risk sensitivity.

Parameter estimation practices and fixed supervisory parameters

In the EU, the single rule book is being rolled out through new and common standards from the EBA.

For instance, the EBA standards and works undertaken to align default definitions, PD computation, treatment of defaulted assets as well as downturn LGD, is a significant step in the right direction, i.e. contributing to comparability, reducing complexity and maintaining risk sensitivity.

F-IRB

In general we understand the need to change the method for calculating LGD under the F-IRB approach. However, we believe the method could be made more risk sensitive by adjusting the proposed haircuts and LGD parameters. More specifically, residential real estate should be subject to lower haircuts than commercial real estate. Hence, lower haircuts and LGD values should be more sustainable and relate to actual risks for residential real estate. The lower riskiness of residential real estate compared to commercial real estate is recognised in the current regulatory framework and in the proposed new standardised method and should also be reflected in the F-IRB approach to maintain some degree of risk sensitivity.

Output floors

In Europe, banks provide finance to corporates through direct lending to a greater extent than in the US, where market finance is the primary source of funding for corporates and households. As a consequence, European banks are more sensitive to a regime shift towards a less risk based approach, and could be forced to change their business model and to decrease their direct lending to corporates and households and to shift towards a role as intermediaries. Our view is that parameter floors as suggested in the paper, depending on the calibration, are less harmful than output floors for the banking system.

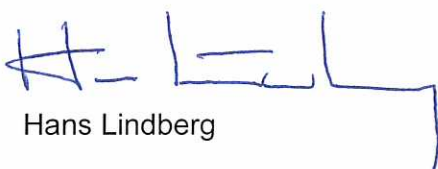
New capital floors, based on the standardised approaches, will hit high quality IRB portfolios disproportionately. For the major Swedish banks these new floors are likely to become the binding capital requirement, given current credit portfolios and a calibration of the floor indicated by the Committee. The proposal also has to be seen together with the expected proposal for a leverage ratio requirement, which is another additional floor on the risk weighted approach and hereby likely to eliminate the risk weighted approach. The leverage ratio and output floors are two methods with the same aim and hereby an example of overregulation.

Capital floors based on the new standardised approach will typically not reflect a bank's risk according to its balance sheet, business model and the markets it operates in. It will present the bank as if its business model is one of a "standardised bank" and as if it operates in different markets than it actually does. The view that capital requirements based on a standardised model will increase comparability is thus flawed. If there are differences in the actual risk in two portfolios belonging to the same exposure class – which is often the case – a capital requirement that at least in some way reflects that actual risk will provide for better comparability than a capital requirement that does not capture the risk at all. Risk-based capital requirements, using banks' internal approaches, will thus cater for better comparability between banks with regard to the capital adequacy and the risk that the bank will not manage unexpected losses.

In general we believe the outcome of the QIS regarding the proposed changes has to be considered before any decision on the final framework is decided. Overall we believe that a revision of the internal risk weighted framework, hereby reducing variation in credit risk weighted assets, should not result in higher capital requirement for the sector in total as well as introducing a permanent output floor should not increase the capital requirements compared with the situation today.

We are of the opinion that revisions of the capital framework (credit risk, market risk, operational risk) should be sufficient to achieve the Committee's purposes and therefore there is no need for output floors.

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