

June 24, 2016

*Via Electronic Mail*

Secretariat of the Basel Committee on Banking Supervision  
Bank for International Settlements  
CH-4002 Basel Switzerland

Re: Comments in Response to Consultative Document – *Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches*

Ladies and Gentlemen:

The Clearing House Association L.L.C.<sup>1</sup> appreciates the opportunity to comment on the Basel Committee on Banking Supervision’s consultative document regarding “*Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches*” (the “**Consultation**”),<sup>2</sup> which would both (i) eliminate a substantial proportion of banking organizations’ credit exposures from the advanced internal ratings based approach (the “**A-IRB Approach**”) altogether in favor of the Standardized Approach and (ii) permanently circumscribe A-IRB Approach capital measures for a separate substantial portion of banking organizations’ credit exposures, including by imposing various standardized exposure and model parameter floors and constraints on model estimation practices.

We appreciate that the Basel Committee is working on a compressed timeline in order to remain “on track to finalize the remaining core elements of the global bank regulatory reform

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<sup>1</sup> The Clearing House is a banking association and payments company that is owned by the largest commercial banks and dates back to 1853. The Clearing House Association L.L.C. is a nonpartisan organization that engages in research, analysis, advocacy and litigation focused on financial regulation that supports a safe, sound and competitive banking system. Its affiliate, The Clearing House Payments Company L.L.C., owns and operates core payments system infrastructure in the United States and is currently working to modernize that infrastructure by building a new, ubiquitous, real-time payment system. The Payments Company is the only private-sector ACH and wire operator in the United States, clearing and settling nearly \$2 trillion in U.S. dollar payments each day, representing half of all commercial ACH and wire volume.

<sup>2</sup> Basel Committee, Consultative Document: *Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches* (March 2016), available at: <http://www.bis.org/bcbs/publ/d362.pdf>.

agenda”<sup>3</sup> by issuing “final standards covering the outstanding revisions to the regulatory framework by end-2016.”<sup>4</sup> However, we do not currently believe that it is possible for any public commenter—or for the Basel Committee itself—to meaningfully identify or assess the potential consequences of the Consultation’s proposed changes given the substantially uncertain context in which those changes have been proposed. First, it is clear that, if enacted, the Consultation would substantially elevate the importance and impact of the Standardized Approach, and yet the Basel Committee has elsewhere undertaken work to substantially revise many aspects of that very same framework. Some of that work—in particular, significant changes to the Standardized Approach to credit risk and a comprehensive overhaul of the operational risk capital framework—remains a work-in-progress, the final shape of which is not expected to be known until later this year. In addition, while other parts of that work—for example, the Fundamental Review of the Trading Book—have been completed, the Basel Committee has not yet undertaken (let alone sought and received public comment on) either the relative or absolute calibration of the revised risk-based capital framework, taking each of the piecemeal changes into account. Regardless of whether one believes that this suite of changes are sufficiently broad and fundamental to represent a “Basel IV” framework—and to be clear, we emphatically do—the result is unambiguous: an environment in which both the methodology and calibration of the various standardized approaches remain a work-in-progress, the final shape of which no one, including the Basel Committee, can possibly know at the present time. And yet it is *precisely* these aspects of the revised standardized framework that the Consultation would effectively impose, either directly or indirectly, on a large portion of banking organizations’ credit exposures.

Moreover, at the same time that the Basel Committee has sought through the Consultation to propose a series of changes to the A-IRB Approach, there is substantial uncertainty about the future role and relevance of the IRB capital measures themselves. For example, in the United States, supervisors are engaged in active conversations regarding whether the IRB advanced approaches should be removed from the U.S. capital framework entirely. And indeed, at the Basel Committee level, we note that the Consultation itself—for the first time, in a single sentence, and without any supporting discussion or elaboration—would effectively make the entire result of the multi-year Basel II process that culminated in the IRB approaches *optional*.<sup>5</sup> Again, it is hard to understand how anyone—the Basel Committee included—can begin to assess the appropriateness and consequences of the proposed changes to the A-IRB Approach when one cannot even know *whether and how the A-IRB Approach will apply*.

Simply put, although there may be significant merit in evaluating and improving the A-IRB Approach, the Consultation’s attempt to do so is fundamentally premature and inappropriate

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<sup>3</sup> Basel Committee on Banking Supervision, *Finalising post-crisis reforms: an update – A report to G20 Leaders* (Nov. 2015) at 1, available at: <http://www.bis.org/bcbs/publ/d344.pdf>.

<sup>4</sup> *Id.*, at 11.

<sup>5</sup> “Regarding the use of internal models for calculating regulatory capital, jurisdictions will be considered compliant with the Basel framework if they do not implement any of the internally modelled approaches (ie they allow use of the standardised approaches only).” Consultation at 3.

at this time. In order for the Basel Committee to make an informed, thoughtful decision about what parts of the A-IRB Approach ought to be eliminated or circumscribed in favor of the Standardized Approach or otherwise, it must first address the basic and fundamental questions that form the context of that decision, including (i) the final contours of the Standardized Approach and (ii) whether and how the resulting A-IRB Approach framework would apply. Moving forward with substantial changes to the A-IRB Approach before these prerequisite matters are addressed would undermine the credibility of the Basel Committee's process for revising its capital framework. For these reasons, we urge the Basel Committee to withdraw the Consultation at this time, so that the key underlying questions may be resolved and any further measure can be properly considered in an appropriately holistic review of the entire package of revisions being considered by the Basel Committee.

Part I of this letter discusses the importance of providing subject banking organizations with the opportunity to evaluate holistically the entire package of revisions to the Basel III capital framework and the data upon which such revisions are made; Part II explains our concern that the effect of the recent proposals will be to fundamentally change the way in which risk-weighted assets are calculated and to increase capital requirements without properly considering and accounting for the reality that stressed measures of risk-weighted assets as implemented by national jurisdictions—not the regulatory minimums—represent the true binding constraint for many banking organizations.

**I. The Basel Committee has undertaken a near wholesale revision of the Basel III capital framework in a fragmented manner, with insufficient attention to the overall coherence of the changes contemplated. Given both the potential problematic interactions among the various proposed revisions and their ultimate cumulative impact, it is essential that the Basel Committee provide an opportunity for comment on the complete package of reforms, presented holistically, and including the data upon which such reforms are based.**

An overarching concern with respect to each of the recently proposed Basel Committee revisions to the Basel III framework, including the Consultation, is the piecemeal approach by which changes are being proposed and decided. The Committee has pursued these revisions in a series of distinct and separate steps, thereby making it almost impossible to comment on the entire package of reforms, their interactions, and their cumulative effects. In addition to the proposal at hand, the Basel Committee has undertaken or announced<sup>6</sup> a number of potentially substantial revisions to the Basel III capital framework, including:

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<sup>6</sup> See Basel Committee on Banking Supervision, *Finalising post-crisis reforms: an update – A report to G20 Leaders* (Nov. 13, 2015); see also Speech by Stefan Ingves, Chairman of the Basel Committee and Governor of Sveriges Riksbank, 2015 Annual Convention of the Asociación de Mercados Financieros (Nov. 2, 2015).

- Revisions to the standardized approach for credit risk (the “**Basel SACR**”),<sup>7</sup> including:
  - Calibration of new risk weights for exposure classes based on QIS data;
  - Calibration of revised credit conversion factors (“**CCFs**”);<sup>8</sup>
- Revisions to the leverage ratio framework;<sup>9</sup>
- Revisions to the standardized measurement approach for operational risk;<sup>10</sup>
- Fundamental review of the trading book, which includes revisions to the boundary between the banking book and the trading book;<sup>11</sup>
- The possible imposition of a step-in risk capital requirement;<sup>12</sup>
- Incorporation of minimum haircuts into the capital requirements for certain securities financing transactions;<sup>13</sup>
- Incorporation of “simple, transparent and comparable” securitizations criteria into the capital framework;<sup>14</sup>
- Introduction of three potential capital floors methodologies to the internal ratings-based approach, including one based on the Standardized Approach as a whole;<sup>15</sup>

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<sup>7</sup> Basel Committee, *Second Consultative Document: Revisions to the Standardised Approach for Credit Risk* (Dec. 2015), available at: <http://www.bis.org/bcbs/publ/d347.pdf>.

<sup>8</sup> The Basel SACR’s revised CCFs will necessarily lead to increased risk-based capital requirements for certain off-balance sheet commitments. If these same CCFs are ultimately incorporated into the current Basel III internationally agreed upon leverage ratio denominator exposure measure, leverage ratio capital requirements would necessarily increase. We are deeply concerned that this increase would be unjustified and would make the already blunt leverage ratio instrument more of a binding constraint and further depart, as a practical matter, from the Basel Committee’s stated policy of the leverage ratio acting as a supplementary, back-stop measure to risk-weighted asset calculations.

<sup>9</sup> Basel Committee, *Consultative Document: Revisions to the Basel III Leverage Ratio Framework* (Apr. 2016), available at: <http://www.bis.org/bcbs/publ/d365.pdf>.

<sup>10</sup> Basel Committee, *Consultative Document: Standardised Measurement Approach for Operational Risk* (Mar. 2016), available at: <http://www.bis.org/bcbs/publ/d355.pdf>; see also Basel Committee, *Consultative Document: Operational Risk – Revisions to the Simpler Approaches* (Oct. 2014), available at: <http://www.bis.org/publ/bcbs291.pdf>.

<sup>11</sup> Basel Committee, *Consultative Document: Fundamental Review of the Trading Book: Outstanding Issues* (Dec. 2014), available at: <http://www.bis.org/bcbs/publ/d305.pdf>.

<sup>12</sup> Basel Committee, *Consultative Document: Identification and Measurement of Step-In Risk* (Dec. 2015), available at: <http://www.bis.org/bcbs/publ/d349.pdf>.

<sup>13</sup> Basel Committee, *Consultative Document: Haircut Floors for Non-Centrally Cleared Securities Financing Transactions* (Nov. 2015), available at: <http://www.bis.org/bcbs/publ/d340.pdf>.

<sup>14</sup> Basel Committee, *Consultative Document: Capital Treatment for “Simple, Transparent and Comparable Securitisations* (Nov. 2015), available at: <http://www.bis.org/bcbs/publ/d343.pdf>.

- Review of the credit valuation adjustment risk framework;<sup>16</sup>
- Revisions to Pillar 3 disclosures requirements;<sup>17</sup> and
- Implementation of rules relating to the treatment of total loss absorbing capacity holdings.<sup>18</sup>

Taken together, these revisions would effect a near wholesale revision of the Basel III capital framework, undertaken in a series of separate steps where different elements are finalized at different times rather than through a deliberate, comprehensive and synchronized review. This approach is concerning in its own right – indeed, it fundamentally undermines the Basel Committee’s process for soliciting and considering public comment on revisions to its capital framework. The Consultation itself states that, “[t]he proposals in this consultation document ... potentially give rise to additional consequential amendments that may be necessary to promote consistency in the framework.”<sup>19</sup> This statement is in and of itself reflective of the issue at hand. If, in enacting what amounts to a complete overhaul of the Basel III capital framework, the Basel Committee “gets it wrong”—and The Clearing House has previously submitted empirical data to the Basel Committee that persuasively demonstrates that the Basel Committee did “get it wrong” in the area of proposed changes to CCFs<sup>20</sup>—the adverse consequences are likely to be substantial.

Moreover, in advance of finalizing and evaluating the cumulative impact of these and other revisions to the Basel III capital framework, the Basel Committee is now attempting to layer the proposed Standardized Approach-based constraints onto the calculation of risk-weighted assets under the A-IRB Approach as set forth in the Consultation. This approach to implementing revisions to the capital framework does not provide banking organizations, market participants or other interested parties with any meaningful opportunity to holistically review and comment on the entirety of the Basel Committee’s revisions in the same manner afforded during the Basel II and Basel III processes. Rather, banking organizations are in the untenable position of having to evaluate and comment on each proposal in isolation, without the benefit of considering the potential cumulative effects of the various proposals in the aggregate.

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<sup>15</sup> Basel Committee, *Consultative Document: Capital Floors: The Design of a Framework Based on Standardised Approaches* (Dec. 2014), available at: <http://www.bis.org/bcbs/publ/d306.pdf>.

<sup>16</sup> Basel Committee, *Consultative Document: Application of Own Credit Risk Adjustments to Derivatives* (Dec. 2011), available at: <http://www.bis.org/publ/bcbs214.pdf>.

<sup>17</sup> Basel Committee, *Consultative Document: Pillar 3 Disclosure Requirements – Consolidated and Enhanced Framework* (Mar. 2016), available at: <http://www.bis.org/bcbs/publ/d356.pdf>.

<sup>18</sup> Basel Committee, *Consultative Document: TLAC Holdings* (Nov. 2015), available at: <http://www.bis.org/bcbs/publ/d342.pdf>.

<sup>19</sup> Consultation, at 13.

<sup>20</sup> The Clearing House, *TCH Research Study: Empirical Analysis of BCBS-Proposed Revisions to the Standardized Approach For Credit Risk* (May 2016), available at: <https://www.theclearinghouse.org/issues/articles/2016/05/20160520-tch-analyzes-bcbs-revisions-to-the-standardized-approach-to-credit-risk>.

Indeed, the Proposal explicitly states that the Basel Committee is “mindful of the relative calibration of the standardi[z]ed and IRB approaches” and intends to, “[l]ater in the process ... return to this issue ...”<sup>21</sup> Simply put, this “revise now and calibrate later” approach serves to obfuscate key issues and decisions, not inform them. Consider, for example, the interplay between the recent consultation on the Basel SACR and this Consultation. While this Consultation relies heavily on the Basel SACR, the comment period for the revisions to that framework closed before this Consultation was even released. In preparing comments on the Basel SACR, banking organizations and other interested parties had no way of knowing how prominently the standardized risk weights under that framework would feature in the Basel Committee’s review of the A-IRB Approach. And likewise, as the Basel SACR has not yet been finalized, commenters may otherwise never have an opportunity to provide views on this Consultation relative to the actual, final Basel SACR on which it would substantially rely.

The wide range of possible outcomes that result from the lack of specificity and high degree of optionality retained by the Basel Committee with respect to the exact calibration of the parameter constraints proposed in the Consultation makes it difficult for interested parties to provide meaningful comments. For example, the instructions released in April 2016 for the Basel III monitoring *ad hoc* exercise include conservative input floors for the A-IRB Approach that are not included for comment in the Consultation, but may in fact inform the Committee’s final calibration of the proposed revisions. Prior to the finalization of the Consultation and its related calibrations, interested parties should be provided with the opportunity to comment on the proposed revisions together with all related calibrations to enable a holistic review of the proposed revisions. This issue is even more important given the fact that the Basel Committee has not yet announced whether it will provide an opportunity for public comment on any proposed calibrations.

There are also a number of other specific examples of potentially significant interactions among the piecemeal revisions to the Basel capital framework. Indeed, in addition to the proposed revisions to the Basel capital framework listed above, the Basel Committee has finalized a number of revisions that are now closed to further comment but which may interact with other proposals still under consultation in ways that were not apparent at the time the revisions were open to comment. One example is the interaction between the Consultation and the Basel Committee’s finalized revisions to the securitization framework.<sup>22</sup> Given that under the IRB approach for calculating securitization risk-weighted assets banking organizations are required to calculate both the IRB risk weights of the collateral pool and loss given default (“**LGD**”), as inputs into the calculation, the Consultation’s restriction on the use of IRB risk weights for exposures to large corporates is inappropriate. It is unclear how the securitization requirements should be calculated for a collateralized loan obligation for which the underlying collateral pool is made up of loans to large corporates. A second example is the revised measure of exposure at default according to the standardized approach for counterparty credit risk, or SA-

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<sup>21</sup> *Id.*

<sup>22</sup> Basel Committee on Banking Supervision, *Basel III Document – Revisions to the securitisation framework* (Dec. 2014), available at: <http://www.bis.org/bcbs/publ/d303.pdf>.

CCR, included in the Basel Committee’s final standard for measuring and controlling large exposures,<sup>23</sup> which is now proposed as a floor on the measurement of derivatives exposures under the internal model method for counterparty credit risk.<sup>24</sup> Although the proposals included in the Consultation are likely to have a meaningful impact on the implementation of these final frameworks, banking organizations were obviously unable to analyze or appropriately comment upon these interactions at the time the revisions to the respective frameworks were under consultation.

Another example of the inherent draw-backs of the Basel Committee’s piecemeal approach to revising the Basel III capital framework is in the calculation of expected credit losses (“**ECL**”), which for regulatory capital purposes is calculated based on modeled estimates of the probability of default (“**PD**”), LGD and exposure. Indeed, the Enhanced Disclosure Task Force of the Financial Stability Board (“**FSB**”), in its comments on the International Accounting Standards Board’s introduction of the new approach to determining ECL,<sup>25</sup> noted that the new method “is likely to be more complex, with a number of banks expecting to use models with comparable complexity to those used for their IRB advanced approaches for capital purposes.”<sup>26</sup> The Consultation, however, would disallow the use of IRB risk weights for exposures to banks, financial institutions and large corporates without regard to the implications for the calculation of ECL more generally.

As a result, proper evaluation of the various proposed revisions requires a constructive and holistic review process, which in turn requires that interested parties be offered the opportunity to comment on and engage with the Basel Committee to discuss areas of concern on the entire suite of revisions taken together and their interactions with one another—not merely disjointed solicitations on each component part of the larger whole. Additionally, we are concerned that failure to solicit comment on the comprehensive set of reform measures that will fundamentally revise the internationally agreed upon regulatory capital framework, and disclose the data upon which its underlying determinations are made, could very well undermine public confidence in the continued credibility of the Basel Committee’s process in the area of regulatory capital.

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<sup>23</sup> Basel Committee on Banking Supervision, *Supervisory framework for measuring and controlling large exposures* (Apr. 2014), available at: <http://www.bis.org/publ/bcbs283.pdf>.

<sup>24</sup> Consultation, at 5.

<sup>25</sup> New ECL standards were also recently released by the U.S. Financial Accounting Standards Board in Accounting Standards Update No. 2016-13 on June 16, 2016.

<sup>26</sup> Financial Stability Board, *Impact of Expected Credit Loss Approaches on Bank Risk Disclosures – Report of the Enhanced Disclosure Task Force* (Nov. 30, 2015), available at: <http://www.fsb.org/wp-content/uploads/Impact-of-expected-credit-loss-approaches-on-bank-risk-disclosures.pdf>. The report further notes that “[i]t is possible that existing regulatory capital requirements will be revised by the Basel Committee in due course as a result of the new [accounting] ECL methodology. An assessment of the potential combined impact of any such changes should be provided once they become known with sufficient reliability.”

In light of the foregoing, we respectfully request, prior to the finalization of the Basel Committee's reform package, including the Consultation after it has been withdrawn and more appropriately repropose as set forth above, that the Basel Committee provide a meaningful opportunity for comment on the entirety of the Basel Committee's proposed revisions and calibrations, in order to permit a holistic review of the cumulative effect of the proposed revisions and their intended coherence with each other. The Basel Committee should not rule out the possibility that further rule changes may be required to harmonize the various proposals, particularly in light of the significant interactions among these proposals. The opportunity to comment on the entirety of the Basel Committee's proposed reforms will assist in evaluating whether the proposed reforms are consistent with one another and with other related rules, provide the Basel Committee with comments on the overall effect of the reforms, and, we believe, ultimately result in more informed revisions and appropriate calibrations.

**II. Further standardization of approaches to measuring risk-weighted assets under the IRB approaches is unnecessary to address the Basel Committee's concern regarding variability, and is nearly certain to result in an overall increase in the minimum capital requirements absent significant recalibration.**

The Consultation proposes to remove the IRB approaches for certain categories of exposures, including banks and other financial institutions, large corporates and equities, based on the Basel Committee's view that there is not enough bank-specific default data for those exposures to give banks a comparative advantage (as compared to using the Standardized Approach) in terms of modelling these exposures.<sup>27</sup> In addition, with respect to certain corporate exposures and exposures to retail classes such as mortgages and credit cards, the Consultation recommends the imposition of exposure-level floors on the model parameters (PD, LGD and the CCF used to determine exposure at default for off-balance sheet items) that banks use for portfolios that remain eligible for application of the IRB approaches. Finally, the Consultation also recommends "parameter estimation practices and fixed supervisory parameters" for:

- the modelling of PD for corporate and retail exposures;
- a parameter on bank-modelled LGDs for corporate and retail exposures, including estimation of:
  - a long-run average LGD for each exposure; and
  - a downturn add-on component for LGD (to which the Basel Committee "will consider applying a floor" in addition to the overall LGD floor, or a supervisor-specified add-on);
- a supervisory-determined floor on downturn LGDs for fully and partially secured corporate and retail exposures (other than the residential mortgages portfolio); and

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"It is unlikely, therefore, that banks' internal estimates of potential defaults or losses from such exposures will be any more reliable from a supervisory perspective than using estimates based on market data, on which the standardi[z]ed approach to credit risk is based." Consultation, at 3.



- modelling the effects of collateral for unsecured exposures using the F-IRB approach for fully and partially secured exposures.

These new practices and parameters would essentially require some variant of a standardized overlay developed by the Basel Committee—without disclosure of relevant underlying data and related considerations—to be applied to each exposure type for which the A-IRB Approach continues to be permitted, including those subject to the floors discussed above.

- A. While imposing standardized overlays and exposure-level floors onto the A-IRB Approach may decrease variability to some extent, the concurrent decreases in risk sensitivity and related effects pose other risks and unintended negative consequences, which outweigh any purported benefits of any such changes.**

The proposed changes to the A-IRB Approach introduced by the Consultation are meant to “address excessive variability in the capital requirements for credit risk” based on “various analyses conducted by the Basel Committee that show significant unwarranted variability in risk-weighted assets calculated under the IRB approaches.”<sup>28</sup> More specifically, the Basel Committee references its study published in July 2013 finding a “high degree of consistency in banks’ assessments of the relative riskiness of obligors,” coupled with “notable dispersion in the levels of estimated risk, as expressed in the PD and LGD that banks assigned to the same exposures.” The Basel Committee cites the “low-default nature of the assessed portfolios, and the consequent lack of appropriate data for risk parameter estimation” as one of the key factors leading to differences across banks.<sup>29</sup> The Basel Committee goes on to state that “[m]uch of the variation (up to three quarters) is explained by the underlying differences in the risk composition of banks’ assets, reflecting differences in risk preferences as intended under the risk-based capital framework.” While we recognize that there may be some variation in risk weighted assets due in part to differences in local implementation and supervisory overlay, it is, at minimum, far from clear that the Basel Committee should simply assume that all variability in banking organizations’ estimates of risk is inherently problematic. In fact, some variability inevitably results from the differing risk profiles among banking organizations—one of the intended benefits of the Pillar 1 minimum capital requirements.

- 1. It is not at all clear that some diversity in risk determinations across banking organizations subject to the A-IRB Approach is intrinsically problematic, and there are systemic risks inherent in basing minimum capital requirements on uniform measurements of risk.**

It is impossible for any entity attempting to measure credit risk, including the Basel Committee or a national supervisor, to be certain *ex-ante* that its measurements are accurate. A primary criticism of model-based measures is that different entities using them may arrive at different estimates for a similar risk, as indicated by the Basel Committee’s variability

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<sup>28</sup> Consultation, at 2.

<sup>29</sup> Consultation, at 3.

assessments described above. However, the total lack of variation that would result from the imposition of highly standardized, non-granular risk weights may have real harmful consequences for financial stability and economic growth. First, a major reason banking organizations using risk-sensitive measures vary in their results is that measuring risk can be a very difficult task. In most cases, different outcomes reflect a genuine—and, in the majority of cases, appropriate—range of views with respect to the variables informing given risks and their relative weights. Only in hindsight is one capable of concluding that a given view was the most accurate at the time.<sup>30</sup> Decreased risk sensitivity in favor of uniform approaches that are poorly calibrated may thus serve to reduce resilience in the banking sector by essentially inducing a very high positive correlation in market behavior, as banking organizations will be incentivized to take the same actions in periods of market stress. There is a real danger that less variability in individual bank risk assessments—the very result of relying solely on standardized risk measures for various exposures—leads to shared orthodoxy and a false sense of security.

Indeed, warranted variability across banking organizations in models used to measure risk should actually help protect the financial system. The most recent financial crisis clearly demonstrates the systemic risk that is created when entities across the financial system allocate assets based on a uniform view of the risks posed by various categories of exposures, including mortgages, money market mutual funds and short-term funded investment banks. Similarly, the U.S. thrift crisis in the 1980s involved thousands of banks—including many small banks—taking a uniform view of the risk of real estate lending. Creating a capital system in which capital requirements are determined based solely on supervisor-driven assessments as to the relative risk posed by various exposure classes may very well introduce dangerous systemic risk, the very issue capital requirements are designed to address. It is far from clear that eliminating variance via standardized overlays and exposure-level constraints on the A-IRB Approach is the most suitable approach to addressing any unwarranted variability in risk measurement across banking organizations under the A-IRB Approach. Such drastic standardization does not address variability in a targeted manner, but rather serves to effectively eliminate the possibility of variability, even in cases where variability may be warranted or justified.

Finally, a regulatory system should embrace warranted diversity in risk determinations in order to guard against the inherent hindsight bias of overly standardized approaches. The stakes here are large if the capital levels required by revised standardized approaches are set so high as to displace banking organizations' own assessments of risk and drive how they decide to allocate capital across businesses. This, in turn, drives the allocation of credit and liquidity across the economy and markets. It is also undeniable that imposing overly high capital requirements on

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<sup>30</sup> “Given the ... rapid state of evolution of these models, [regulatory standards for internal credit risk models] should not be highly restrictive ... since at present there is *little basis for concluding that one specific approach to credit risk modeling is uniformly better than all others in all situations* [emphasis added].” Hirtle, Beverly et. al., *Using Credit Risk Models for Regulatory Capital: Issues and Options*, FRBNY Economic Policy Review (Mar. 2001) at 24, available at: <https://www.newyorkfed.org/medialibrary/media/research/ep/01v07n1/0103hirt.pdf>.

banks harms the global economy by limiting access to financing and liquidity.<sup>31</sup> As a result, credit may be misallocated across the banking system, not just within an individual banking organization, if standardized measures introduced as exposure-level constraints on the A-IRB Approach, or as part of a separate Standardized Approach, are not measuring risk correctly.

Because it is unclear that eliminating variability is an appropriate goal to which the Basel Committee's revisions to the capital framework should be directed, it is therefore also unclear what, if any, benefit will be attained by implementing the standardized overlays and other constraints included in the Consultation – though it is clear that implementing the proposed changes may very well introduce other problems into the overall regulatory capital framework.

**2. The Basel Committee's proposed means of addressing variability—imposing standardized overlays and exposure-level floors onto the A-IRB Approach—is unlikely to produce accurate measurements of risk over the long term.**

Introducing standardized overlays and exposure-level floors onto the A-IRB Approach is unlikely to result in a more accurate measure of risk for several reasons. First, assigning standardized risk weights to various asset classes requires regulators to collapse the more precisely defined, and in some cases idiosyncratic, subcategories used by banking organizations into more broadly defined asset classes determined on the basis of supervisory judgments and subsequently fixed by regulation. Put differently, because standardized measures require standardized categories, they inevitably involve the collapse of assets with widely varying risk profiles into a single category assigned a single risk measure. The expansion of the number of risk-weight categories afforded by the introduction of the A-IRB Approach was intended to better recognize the differentiation in credit quality among individual exposures. Credit card loans are an excellent example of this shortcoming in the approach outlined by the Basel Committee: notwithstanding the major variance in risk across different market segments and borrower types, the Basel SACR assigns the same risk weight to all credit card balances. The overall reduction in the number of asset subcategories results in a dramatically less precise and, as a result, less accurate measurement of risk. Layering exposure-level floors on the model parameters for these portfolios further constrains the ability, under the proposed A-IRB Approach, to account for and accurately reflect the diversity of risk characteristics within these portfolios.

Second, standardized measures of risk may not reflect the benefits of diversification. Rather, they generally treat every balance sheet as the simple sum of its parts and fail to account for the risk reduction attendant to diversified exposures. This contrasts with stress testing, which does recognize the benefits of diversification and banking organizations' own risk management

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<sup>31</sup> See Seung Jung Lee & Viktors Stebunovs, "Bank Capital Pressures, Loan Substitutability, and Nonfinancial Employment," Int'l Fin. Discussion Papers, Bd. of Governors of the Fed. Reserve System (April 2016), available at: <https://www.federalreserve.gov/econresdata/ifdp/2016/files/ifdp1161.pdf> (demonstrating that stronger capital requirements can lead to slower employment growth in industries that depend on external finance).

practices, which in turn take into consideration the interrelationships between various lines of business.

Third, internationally developed standardized approaches and their calibration are the product of development by the Basel Committee through closed negotiations and, often times, compromises among members representing jurisdictions with very different banking systems and political priorities. This “least common denominator” approach favored by the Basel Committee can generate distortions and introduce inefficiencies. The Basel SACR, for example, assumes that the risk of credit cards cannot be modeled, reflecting a sensible assumption with respect to the many countries that do not have a history of credit card lending, but reflecting a false premise for others, including the United States. Indeed, the Basel Committee candidly notes in the Consultation that high parameter floors risk unduly affecting retail portfolio products that have specific national features that result in lower default rates and loss rates than similar products in other jurisdictions; however, the Basel Committee does not propose any means by which to address this issue.

Finally, by imposing standardized-based parameters on risk weight measurements under the A-IRB Approach, the Consultation would establish its determinations of relative risk based on the current economic environment. Even if accurate when initially made, the determination as to the relative level of risk posed by a particular exposure type is rather unlikely to remain accurate over the long term. As the global economy continuously evolves, so too do the relative risks of various exposures, and the A-IRB Approach was designed to allow for that evolution to be appropriately reflected in regulatory capital measurements. The Consultation’s prescriptive limits on various risk exposure measures in the A-IRB Approach—by means of both suggested exposure-level floors on the A-IRB Approach portfolios and standardized parameter estimation practices—will likely fail to account for the inevitable changes in the risk levels of these portfolios that will occur over time. As a result, cementing standardized risk measures in various forms in the A-IRB Approach will be difficult to revisit and adjust even if regulators identify inaccuracies or other compelling reasons to do so absent a readily ascertainable alternative calculation as embodied by an unadulterated A-IRB Approach.

**B. Further increasing minimum capital requirements as a possibly unintended by-product of addressing variability is likely to impose tangible costs on the broader economy, particularly in those jurisdictions that have in place robust stress testing regimes.**

While the Consultation reiterates that significantly increasing overall capital requirements is not a stated objective of the Basel Committee,<sup>32</sup> recent actions of the Basel Committee suggest

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<sup>32</sup> Consultation, at 2. Indeed, in an April communique, the G20 finance ministers and central bank governors “reiterate[d] [their] support for the work by the Basel Committee to refine elements of Basel III framework to ensure its coherence and maximize its effectiveness *without further significantly increasing overall capital requirements across the banking sector*” [emphasis added]. Communique: G20 Finance Ministers and Central Bank Governors Meeting, April 14-15, 2016, Washington, D.C., available at: <https://www.imf.org/external/np/cm/2016/041616.htm>.

that, once finalized, the totality of recently proposed changes to the Basel III capital framework will in fact increase capital requirements as a practical matter. The Basel Committee has, for example, already acknowledged that a 40 percent increase in trading book capital requirements is expected as a result of its fundamental review of the trading book exercise and that capital requirements for securitizations will increase under the revisions finalized in December 2014.<sup>33</sup> We are concerned that the standardized constraints proposed in the Consultation are also likely to result in a major overall increase in risk-based capital. There are tangible costs to the broader economy of requiring banks to hold inordinately high levels of capital—such as impaired market liquidity and increased costs to customers—that can be difficult to quantify. Raising the relative levels of capital required with respect to certain asset categories may require subject banking organizations to limit or discontinue certain business activities, thereby imposing costs on customers that rely on banking organizations for financial services, investors, markets and on the broader economy. Indeed, as banking organizations subject to inappropriately calibrated capital requirements gradually reduce or abandon business lines that are unduly impacted by increasingly inflexible standardized measures of risk, the resulting gap in the provision of banking services could very well drive significant credit intermediation into the less regulated sector. As a result, raising capital requirements to unnecessarily high levels will encourage the growth of the significantly less regulated and less transparent shadow banking system, including non-bank financial intermediation and maturity transformation. Encouraging non-bank entities and transactions to operate on a large scale in ways that create bank-like risks to financial stability increases systemic risk in the financial sector. As acknowledged by the FSB, “a leveraged and maturity-transforming shadow banking system can be vulnerable to ‘runs’ and generate contagion risk, thereby amplifying systemic risk [and] [s]uch activity, if unattended, can also heighten pro-cyclicality...”<sup>34</sup> There is no real debate as to whether higher bank capital requirements can and do slow banking activity and reduce economic growth.<sup>35</sup> The real question is at what point will such consequences begin to outweigh, from a policy perspective, the perceived increases in the resiliency of banking institutions and of the financial system as a whole. We may not know precisely where the tipping point is, but it surely exists. Prolonged weak economic performance in the United States and Europe, including very low or negative interest rates, may either be indicative that we are nearing such a tipping point and/or that as the banking industry is becoming more and more constrained in its fundamental credit intermediation function by ever higher capital requirements, its ability to play its traditional role in helping spur economic growth is being consequently reduced.

Furthermore, the Consultation fails to account for the fact that, as a practical matter, in many jurisdictions the binding requirements are determined not by the calculation of risk-

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<sup>33</sup> Basel Committee, Explanatory Note on the Revised Minimum Capital Requirements for Market Risk (Jan. 2016), *available at*: [http://www.bis.org/bcbs/publ/d352\\_note.pdf](http://www.bis.org/bcbs/publ/d352_note.pdf).

<sup>34</sup> Financial Stability Board, “Strengthening Oversight and Regulation of Shadow Banking – Regulatory Framework for Haircuts on Non-Centrally Cleared Securities Financing Transactions” (Oct. 14, 2014), *available at*: [http://www.financialstabilityboard.org/wp-content/uploads/r\\_141013a.pdf](http://www.financialstabilityboard.org/wp-content/uploads/r_141013a.pdf).

<sup>35</sup> Basel Committee on Banking Supervision, “An assessment of the long-term economic impact of stronger capital and liquidity requirements” (August 2010), *available at*: <http://www.bis.org/publ/bcbs173.pdf>.

weighted assets under either the A-IRB Approach or the Standardized Approach, but rather by the minimum capital levels necessary to pass rigorous stress tests. Jurisdictions including the United States,<sup>36</sup> the European Union<sup>37</sup> and the United Kingdom,<sup>38</sup> to name a few examples, have in place robust stress testing regimes under which the assessment of a banking organization's capital typically includes a supervisory assessment of the institution's ability to maintain adequate capital above each minimum regulatory capital ratio under baseline and stressful conditions throughout a predetermined time frame. Some variability in the calculation of risk-weighted assets under the A-IRB Approach is of little consequence when one considers that subject banking organizations will necessarily incorporate a significant buffer above and beyond the baseline regulatory minimums in order to ensure that the institution does not fall below such minimums under stressed conditions. Indeed, if the practical import of the Basel Committee's recent proposals is to effectively increase the baseline minimum capital ratios that must be maintained under stressed conditions, the result will be imposition of overly high capital requirements, absent a comprehensive recalibration of supervisory stress testing regimes, the underlying capital requirements, or both. Such a result would only serve to further exacerbate the risks to the broader economy discussed above.

We therefore urge the Basel Committee to expressly consider the potential harm to the global economy that may result from proposed revisions to its capital framework that, taken together, are likely to impose unduly high capital requirements, and to refrain from implementing the revisions proposed under the Consultation until the entire package of reforms

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<sup>36</sup> Capital planning and stress testing are two key components of the Federal Reserve's supervisory framework for large financial companies. There are two related components of the framework: the Comprehensive Capital Analysis and Review ("**CCAR**"), which is conducted pursuant to the Federal Reserve's capital plan rule (12 CFR 225.8), and stress testing, which is conducted pursuant to the Federal Reserve's stress test rules (subparts E and F of Regulation YY) and section 165(i) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. In CCAR, bank holding companies that have total consolidated assets of \$50 billion or more (large bank holding companies) submit capital plans to the Federal Reserve, and the Federal Reserve assesses the internal capital planning processes and ability of these firms to maintain sufficient capital to continue their operations under expected and stressful conditions. As a complement to CCAR, the Federal Reserve conducts annual supervisory stress tests of large bank holding companies, and these bank holding companies must conduct annual and mid-cycle company-run stress tests.

<sup>37</sup> The European Banking Authority ("**EBA**") Regulation gives the EBA the power to initiate and coordinate the EU-wide stress tests, in cooperation with the European Systemic Risk Board ("**ESRB**"). The aim of such tests is to assess the resilience of financial institutions to adverse market developments, as well as to contribute to the overall assessment of systemic risk in the EU financial system. The EBA's EU-wide stress tests are conducted in a bottom-up fashion, using consistent methodologies, scenarios and key assumptions developed in cooperation with the ESRB, the European Central Bank and the European Commission.

<sup>38</sup> The stated purpose of the Bank of England's concurrent stress-testing framework is to support both its Financial Policy Committee and the Prudential Regulation Authority in meeting their statutory objectives by providing a quantitative, forward-looking assessment of the capital adequacy of the UK banking system and individual banks within it by annually designing and running a stress scenario, the severity of which will vary through time based on the Bank of England's assessment of the risks facing the banking system in the UK and globally.

is consciously undertaken with careful consideration and subject to a holistic and fulsome consultation.

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The Clearing House appreciates the opportunity to comment on the proposal. If you have any questions, please contact the undersigned by phone at (212) 613-9883 or by email at [David.Wagner@theclearinghouse.org](mailto:David.Wagner@theclearinghouse.org).

Respectfully submitted,

A handwritten signature in black ink that reads "David Wagner". The signature is written in a cursive, flowing style.

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*The Clearing House Association L.L.C.*

cc: William Coen  
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