

27 March 2015

Bank for International Settlements
Centralbahnplatz 2
4051 Basel
Switzerland

Dear Sir/Madam,

Basel Committee on Banking Supervision: Consultative Document: Capital Floors: the design of a framework based on standardised approaches

Introduction

Westpac has contributed to both the submissions of the Australian Banker's Association (ABA) and the Institute of International Finance (IIF) but would like to take the opportunity to provide its own feedback to the Committee focusing on the key design issues we believe must be addressed if the proposal of a risk weighted capital floor tied to the standardised approaches is to achieve its stated objectives.

The design issues of a capital floor are complex but the essence of our feedback can be summarised as follows:

- The design should seek to minimise the number of additional floors being introduced. In particular, replicating the proposed aggregate or risk category floors at an exposure class (e.g. corporate, bank, residential mortgages etc.) level would add a layer of complexity that is both undesirable from the perspective of simplicity but also redundant in the light of other BCBS initiatives that offer simpler and more direct solutions to the policy objective exposure class floors would address.
- The design of a risk weighted floor could be made much simpler and more effective if the proposal was focused on achieving one primary objective rather than the three objectives set out in paragraph 13 of the Consultative Document (CD). Westpac believes that the design of the risk weighted capital floor should focus on the objective of addressing any horizontal inequity in standardised and internal model based risk weighted capital requirements.
- The pursuit of horizontal equity should recognise the inherent limitations and implicit portfolio risk assumptions embedded in the standardised approach when comparing standardised capital requirements with an internal model based approach. For example, local market differences in the risk of retail products such as residential mortgages should be considered if they are not explicitly factored into the standardised approach risk weights. Differences in portfolio risk concentration, particularly between large diversified and smaller more regionally concentrated banks are also important. It is not possible to say what kind of horizontally equitable relationship should be set by the risk weighted floor without a clear and explicit understanding of these considerations.

The specific design challenges we have identified are set out in more detail below together with suggestions as to how they could be addressed.

Specific design challenges associated with stated objectives of the proposal

The specific objectives the Committee has assigned to the proposed risk weighted capital floor are to address:

- Excessive Risk Weighted Asset (RWA) inconsistency and dispersion;
- Low level of models-based RWAs for some exposure categories; and
- Horizontal inequity in risk weighted capital requirements between standardised banks and banks using internal models for regulatory capital purposes.

The Committee's approach to designing a mechanism that addresses all of these concerns is predicated on the belief that the design issues can be separated from the issue of calibration and that it is "...possible to calibrate the floor to deliver a similar capital impact **on average**, irrespective of the floor's design" (emphasis added). Westpac supports all of the objectives the Committee is pursuing but has identified the following issues in the general approach and individual design choices laid out in the CD.

Firstly, the principle that a floor can be calibrated to deliver the same impact irrespective of the design choices does not appear to give due consideration to the complications introduced by:

- the fact that the current disparity of risk weight density across banks is due to both valid risk-based and invalid individual measurement practice-based reasons,
- different relative exposures to credit, market, operational and other locally imposed Pillar 1 risks, and
- different supervisory practices in the use of Pillar 1 or Pillar 2 to set capital requirements.

A risk-weighted floor might in principle be designed in a way that overcomes all of these challenges but the end result will be complex and not particularly transparent. We believe that the concern with model based variance in RWA is best addressed in a targeted manner as set out later in this submission rather than indirectly via a floor.

Secondly, the low risk weight exposures objective implies that a risk-weighted floor will be calibrated to target exposures not already captured by the Leverage Ratio. The CD identifies a specific concern with future growth in low risk weight portfolio but it is not clear why such growth would not already be addressed by the Leverage Ratio. The risk weighted floor is also particularly susceptible to the adverse incentive problem by which banks have an incentive to offset growth in low risk weight portfolios by increasing high risk weight exposures. To the extent that the Committee has residual concerns with low risk weight portfolios not already bound by the Leverage Ratio, other initiatives such as minimum risk weights or the permanent partial application of a revised standardised approach¹ to the low default portfolios of concern are more direct, transparent and much simpler solutions without the calibration challenges and potential for unintended consequences presented by a risk-weighted floor approach.

Thirdly, while horizontal inequity is we believe the proper focus of the risk weighted floor proposal, this concern will not be appropriately addressed by simply imposing a RWA overlay on advanced banks that forces a convergence of the standardised and internal model based RWA without proper consideration of why the risk weights are, or should be, different. Such an approach is equivalent to treating the symptoms of a problem rather than its underlying cause. We have set out an outline of the process and sequence we believe is required to design and implement a risk weighted floor that addresses horizontal inequity.

Design and calibration of an effective risk weighted floor

Westpac believes that a two stage process is needed to appropriately address the Committee's objectives and the design challenges listed above. The first stage would see the work on the standardised approach conducted in parallel with efforts to impose greater consistency on definitions and the range of measurement practice allowed by the internal model based approach (by both industry and supervisors).

Fortunately, the program of work required to incorporate greater consistency on definitions and measurement practice has already been well documented. The IIF Risk Weighted Assets (IRTF) Report released in November 2014 included 100 recommendations for harmonising modelling approaches.

¹ Westpac support for the permanent application of the standardised approach would be contingent on the revised standardised approach for these portfolios being appropriately risk sensitive. As it stands the proposals in the consultation on a revised standardised approach do not meet the test of adequate risk sensitivity. Westpac is particularly concerned with the proposal to completely remove all reference to external ratings in the setting of risk weights for corporates and banks. If the test of adequate risk sensitivity cannot be achieved then Westpac would prefer a minimum risk weight constraint on the IRB model.

The BCBS November 2014 report to the G20 “Reducing excessive variability in banks’ regulatory capital ratios” lists a similar range of measures to address the problem, while the European Banking Authority’s March 2015 discussion paper on the “Future of the IRB Approach” also proposes a comprehensive and integrated programme of work that is required to address the root causes of unwarranted variance in risk weights across different banks. Westpac believes that both the industry and supervisory led initiatives offer a practical approach to achieving greater consistency and comparability in internal model based RWA measurement. They do not represent the entire solution but, in combination with an appropriately risk sensitive standardised risk weighted approach, they are an essential component of it.

Importantly, the EBA proposal identifies the need to bring greater consistency to supervisory practices as a fundamental part of the solution. We recognise that this may be perceived to run counter to the principal of allowing supervisors “national discretion”. Different supervisory solutions to similar problems contribute to RWA variance and will significantly complicate the design and calibration process if they persist². The discipline of consistency proposed for supervisors is no different in principle to the standards of consistent practice the IIF has volunteered on behalf of the industry in the IRTF report. We do not seek to challenge the supervisors’ right to impose higher capital requirements where they see fit but simply to point out that inconsistent approaches create practice based variations between the standardised and internal model based approaches.

As noted above, improved, more risk sensitive standardised approaches are also a core part of the design of a simple and effective risk weighted floor. The individual risk weights assigned by the standardised approach are of necessity calibrated to a certain kind of portfolio (i.e. well-diversified, or concentrated) but it is currently far from clear what portfolio the standardised approach is calibrated to. An explicit statement of the risk characteristics of the portfolio to which the standardised approach risk weights are calibrated is essential before we can begin to consider the question of what is the correct and equitable relationship between the RWA of the two different approaches. This is particularly important where the standardised risk weights do not seek to distinguish differences in the composition of credit portfolio such as a regionally focused retail bank and a more geographically diverse retail bank.

Just as there is pressure to increase some of the low risk weights generated by internal models there should be scope for the risk weights of the standardised approach to decline where they are too high relative to the model based equivalent. Any concern that this may lead to an inappropriate decline in capital requirements should be addressed via adjustments to capital buffer requirements.

Building on these foundations, a risk weighted floor based on standardised approaches could then be designed that promoted a logical and equitable relationship between the capital requirements of the standardised and internal model based capital requirements. The goal of simplicity would be best served by a design of the risk weighted floor approach that relied on the minimum number of floors possible. Exposure class floors that extend beyond a simple minimum risk weight constraint on IRB models would not be simple. Combining exposure class floors with aggregate or risk category floors (e.g. credit, market, operational risk) would be even more complex. We believe the marginal benefit and presumed attraction of building multiple layers of redundancy into the capital framework would be outweighed by the added complexity and the fact that there are simpler ways to pursue the specific exposure class concerns.

Conclusion

The specific recommendations we are proposing the Committee employ to achieve the stated objectives of the CD while addressing the design issues we have identified are summarised below:

1. Pursue the excessive model variability objective by
 - implementing a clear and detailed set of prudential risk measurement standards based on the work already completed by the IRTF and use these as the basis of reducing practice based variations in RWA measurement; and
 - developing a clear set of guidelines for supervisors with the objective of reducing variations in RWA caused by inconsistent use of Pillar 1 and Pillar 2 to adjust bank capital requirements;
2. Pursue the concern with low model based RWA’s via targeted solutions such as minimum risk weights or the permanent partial use of the standardised approach] for the exposure classes of concern;

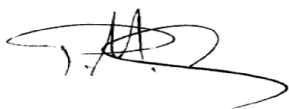
² One example of varying supervisory practice is that some supervisors impose higher risk weights via Pillar 1 adjustments while others use Pillar 2 to require higher capital ratios that have the same effect. A bank that operates under a Pillar 1 adjustment will be potentially impacted differently under the risk-weighted floor proposal than a peer bank operating in a different jurisdiction that is subject to a Pillar 2 adjustment.

3. The design of the risk weight capital floor should focus on the objective of addressing any horizontal inequity in standardised and internal model based capital requirements;
4. The revised standardised approach should clarify what kind of portfolio the standardised risk weights are calibrated to and the extent to which the risk profile of individual bank portfolios would be expected to vary relative to this standardised calibration;
5. Employ the minimum number of floors necessary to achieve the objectives of the CD; and
6. Implement parallel reporting under both the standardised and internal model based approaches but defer the implementation and calibration of hard capital floors until after the initiatives listed above are in place.

Westpac recognises that what we are proposing will take time to complete in the proper sequence. However, we believe that the premature introduction of a new capital floor with the attendant design and calibration problems set out above will divert resources from addressing the underlying problems and ultimately produce an outcome that fails to meet the Committee's objectives.

A risk weighted floor implicitly requires the parallel calculation of capital adequacy under both internal model and standardised approaches but it is not clear if the Committee is proposing parallel reporting of the two measures. The recommendation above to introduce parallel reporting maintains focus on the issues of concern identified by the CD while allowing time to complete all the necessary steps in the proper sequence. This would allow the market to be fully informed of the extent of RWA variance and for banks to have a basis for explaining and justifying the drivers of that variance. This process would bring market forces to bear and assist both banks and supervisors to identify and eliminate unwarranted variances. It may even be that the imposition of an additional floor is judged to be unnecessary at the end of this process but the final design and calibration process would be immeasurably simpler and more transparent.

Yours faithfully,



Philip Coffey
Deputy CEO
The Westpac Group