

24 June 2016

Secretariat
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
SWITZERLAND

Dear Secretariat

BCBS: Consultative Document: Reducing variation in credit risk-weighted assets - constraints on the use of internal model approaches

The Australian Bankers' Association (**ABA**) appreciates the opportunity to provide comments on the Basel Committee on Banking Supervision's (**BCBS**) Consultative Document: *Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches* (**Consultative Document**).

With the active participation of its members, the ABA provides analysis, advice and advocacy for the banking industry and contributes to the development of public policy on banking and other financial services. The ABA works with government, regulators and other stakeholders to improve public awareness and understanding of the industry's contribution to the economy and to ensure Australia's banking customers continue to benefit from a stable, competitive and accessible banking industry.

The ABA supports a simple and comparable capital framework that retains appropriate risk sensitivity. The ABA believes this can be done by ensuring that the internal ratings based (**IRB**) approach continues to be at the core of the capital framework. This will preserve the value that IRB models yield, namely supporting robust risk measurement and empowering risk management practices throughout a bank. ABA members are concerned that the numerous changes proposed in this consultation and other ongoing revisions to the capital framework risk substantially lifting the required amount of capital while foregoing the opportunity to more directly address the problems with risk sensitive capital measures.

In combination, the proposed IRB revisions overlap with various other recent BCBS consultations:

- Leverage ratio revision provides for an aggregate non-risk adjusted measure of capital, similar in nature to application of an aggregate capital floor.
- Standardised approach to counterparty credit risk (SA-CCR) is a variation of exposure measurement.
- Net stable funding ratio (NSFR) places additional constraint on portfolio mix and tenor.
- Credit Valuation Adjustment (CVA) revisions are an additional constraint on counterparty credit risk.

Careful consideration of the interaction between each of these initiatives with the revised IRB and standardised approach (**SA**) proposals will be required to avoid duplicative capital impacts and to avoid unintended outcomes.



More time is required to properly understand, integrate and calibrate the many interlinked aspects of the capital framework the Committee is seeking to finalise. The priority should be to finalise the revised SA and IRB standards and the Quantitative Impact Study (**QIS**). It would then be possible to consult on the capital floor with the benefit of the BCBS's two QIS alongside the Institute of International Finance (**IIF**) Total Capital Study QIS.

The substantial strengthening of capital and liquidity already achieved provides a platform to take the time to complete the necessary changes while minimising the risk of unintended adverse consequences. The financial system has evolved significantly in recent decades and will continue to do so, partly in response to external forces, but also in response to incentives and disincentives embedded in the regulatory framework. It is critical therefore that the capital framework be designed in a way that helps shape the future evolution of the financial system, recognising differences in risk, and not rewarding banks that choose to take on higher levels of risk which the regulatory framework does not measure.

Support for ongoing industry initiatives to address variability

The Committee has valid concerns regarding risk-weighted assets (**RWA**) variance that cannot be explained by differences in risk and with the modelling challenges of low-default portfolios in particular. However, the ABA believes that the Committee's proposals to move certain portfolios from IRB to SA, coupled with the potential application of a high capital floor, lacks risk sensitivity and has the potential to create a disconnection between capital and risk, which could result in an increase of systemic risk in the banking system. More active supervision can of course mitigate these risks. However, the ABA believes it is undesirable to rely too much on supervision to ensure the continued strength of the financial system. Pillars 1 and 2 should mutually reinforce each other.

The ABA and members are committed to working with the Committee, other jurisdictions and national supervisors to address specific concerns with the IRB approach and to restore credibility in the modelled approach. The ABA believes that enforcing greater harmonisation of IRB modelling assumptions and parameters is one of the foundations of an enhanced framework. For example, there is wide interpretation of definitions that affect parameter estimates. More guidance on definitions such as recognition of default, length of loss given default (**LGD**) recovery periods and LGD discount rates, would be welcome. This guidance, in combination with, if necessary, an appropriately calibrated floor over a stable prudential framework would further reduce RWA variability. Fortunately, much of the work required to achieve this outcome has already been completed by the efforts of the IIF RWA Task Force and similar initiatives by the European Banking Authority.

The ABA is supportive of the IIF submission submitted to the Committee on 3 June 2016. The IIF members, cognisant of the BCBS's concerns on RWA variance and data gaps, propose a number of constructive solutions that have the potential to enhance the capital framework and preserve a greater degree of risk-sensitivity whilst also attempting to address the committee's concerns.

The ABA considers that a number of the proposals addressing variability proposed within pillar 1 risk weighted asset calculations are more appropriately addressed within pillar 2 (supervisory review) or pillar 3 (market discipline). The proposals to address variability should take more explicit account of variances introduced by Pillar 2 (supervisory review) and the recently proposed revisions to Pillar 3 disclosures where the common disclosure templates and comparisons to financial reporting will facilitate greater consistency and cross-jurisdictional comparability, and promote the ability for the market to assess underlying risk. This will provide clarity for legitimate jurisdictional differences such as national laws and regulation, accounting practices and domestic supervisory guidance being used in conjunction with Pillar 1 risk-weighted calculations.

It is particularly important that the final calibration of the proposals take account of the variances in risk-weights introduced by different approaches to the use of Pillars 1 and 2. Residential mortgage risk-weights are an example where some jurisdictions, such as Australia, have elected to increase capital requirements via higher risk-weights while other jurisdictions require similar outcomes via higher capital ratio requirements.



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Risk sensitivity and simplicity

While excessive variability must be addressed, the ABA believes it important to preserve models as the primary method of allocating capital in a framework which takes into account all available information to more accurately calibrate relative risks. The ABA is concerned that aspects of the Committee's proposals, in focusing on simplicity, fails to preserve appropriate risk sensitivity and misalign capital with risk. This will have a negative impact on both the availability and cost of credit for the Australian economy. The retention of risk sensitivity is worth the additional complexity.

Given the above, the ABA strongly supports the continued application of IRB as the prime method for determining bank capital requirements. The ABA believes that industry initiatives underway will address many of the concerns of the Committee and potentially negate the need for some of the Committee's proposed constraints on the IRB models, and avoid a material increase in overall capital requirements.

Comments on the proposals

Notwithstanding the above, the ABA takes the opportunity to provide comments on the Committee's proposals as they stand, as there are additional potential enhancements to drive consistent modelling of credit risk, which can be considered by the Committee and complements the work of the IIF RWA Task Force.

Proposed floors and their calibration

The proposals, if implemented in their current form, place restrictions on the calculation of risk-weighted assets on:

- 1) Exposure level (model-parameter input floors)
- 2) Asset class level (restrictions on the use of IRB for certain portfolios); and
- 3) Aggregate level (aggregate output capital floor).

Whilst the ABA recognises that these proposals aim to restrict the capacity for unjustifiably low risk-weights and hence a higher leverage that might otherwise be possible, this approach clearly adds a significant level of complexity, especially if implemented at all three levels to create a 'floors upon floors' framework. Such an approach can only be reconciled with the Committee's desire for greater simplicity if it can be demonstrated that the other measures already introduced or being considered by the Committee will not be sufficient to achieve the goals of comparability and consistency. It is difficult to answer this question without knowing the final form of the IRB framework, inclusive of the effects of this consultation and the revised standardised approach to credit risk, but the ABA believes that restrictions at all three levels are unlikely to be necessary.

In particular, the ABA is concerned about the concept of the proposed aggregate floor. The aggregate floor is intended to replace the floor that was introduced as part of the transition from Basel I to Basel II. The original purpose of this floor was to limit the extent to which a bank's capital requirement could decline excessively as a result of the transition to Basel II. Given the substantial increase in capital requirements already implemented as a result of the various changes introduced under Basel 2.5 and III, the ABA sees no continuing need for such a floor.

If the Committee progresses with the proposed constraints on the IRB approach and model input floors, the use of the leverage ratio should be favoured rather than a binding constraint associated with an output capital floor.



In regards to calibration, and depending on the levels at which any floors are set, the current proposals could potentially impact all major risk types and as a result increase the capital required in the Australian financial system without a commensurate benefit. The ABA notes that the impact for each jurisdiction would be materially different, depending on the domestic implementation of the Basel framework in that jurisdiction. For example, in Australia, APRA currently has imposed a LGD floor of 20 per cent for residential mortgages and if the proposed LGD floor was set above this level, this would increase the capital required for the Australian banks.

In general, downturn LGD add-on (fixed or floored) should vary according to the level of coverage. The application of a prescribed LGD add-on does not adequately recognise the value of over-collateralised exposures where evidenced recoveries indicate no loss will be realised even in the event of default. The ABA recommends that the calibration of any binding constraint on downturn LGD considers greater sensitivity to the type and level of collateral.

A fixed exposure at default floor has the potential to impact small portfolios associated with particular product types. Examples include contingent type off-balance sheet instruments, such as performance or trade related contingencies, where measurement of exposure floors could materially impact trade between mature and developing economies.

Unconditionally cancellable commitments

The proposed revisions to unconditionally cancellable commitments (**UCC**) not currently subject to risk-weighting could materially impact the availability and allocation of credit and does not correctly quantify the underlying risk associated with some lending products or legally binding terms and conditions. In line with the IIF submission, the ABA supports the preservation of low credit conversion factors for both retail and non-retail UCCs where appropriately controlled, provides for a more appropriate capital outcome than proposed.

Exposures to banks, other financial institutions and corporates

The ABA believes that the IRB approach should be retained for banks, other financial institutions, and large corporates despite being difficult to model due to the low-default nature of the portfolios. The ABA believes that IRB models can properly quantify the credit risk and are the best means for delivering the risk-sensitivity necessary in the capital framework.

The ABA believes that mandatory application of the SA to banks, large corporates, and sovereigns will likely result in inappropriate pricing across risk classes/segments. Furthermore, capital requirements for low-risk regulated financial institutions such as banks and insurers, relative to other higher risk financial institutions would increase because the current proposals are not appropriately risk sensitive nor sufficiently granular in the bucketing of risk-weights to be applied to those exposures. At the same time, non-regulated competitors in the shadow banking sector would be able to price their loans at better rates because they are not subject to the same prudential framework, this creates significant potential for increased systemic risk in the Australian financial system.

The ABA agrees with the IBFed position, in that rather than removing the IRB approaches for banks and large corporates, the establishment of certain qualifying criteria (e.g. requirement for a certain amount of observations or data years and a minimum number of defaults) should be considered for these exposures.

In the event that the Committee proceeds with its proposal to require the SA for these exposures, the ABA is in agreement with both the IIF and IBFed that more granularity is needed in the risk-weight buckets than is currently proposed. More granular risk-weights could also be mapped to the bank's internal ratings under the current IRB approach as opposed to qualitative descriptions that are proposed in the Consultative Document.



In addition, the ABA is concerned that secured senior large corporate exposures will lose collateral recognition when moving to the SA or Foundation Internal Ratings-Based Approach (**FIRB**). The ABA considers the IRB modelling of LGD for these exposures is sufficiently reliable and should be retained as the proposed alternative fails to recognise the underlying risk in a risk sensitive way.

The ABA welcomes further industry consultation on the appropriate calibration of large corporate assets and revenue. There are concerns relating to the application of proposed revisions, including appropriateness in the use of consolidated or obligor financial statements and levels of calibration which have potential to provide for risk outcomes not commensurate with legal structures or underlying risks.

For corporate exposures, the use of the consolidated group for measuring total assets and annual revenues means that the scope of the internal model restrictions may not just be low-default exposures as intended in the BCBS proposals. For example, where a corporate group has a subsidiary that does not receive a guarantee or other support from the parent, and is treated as the risk customer from a credit perspective, the rating of that subsidiary is likely to be lower than for the consolidated/parent as a whole. However, the requirement for the assets and revenue test to use the consolidated accounts may lead to the risk customer being classified as a low-default/large corporate and thus subject to internal model restrictions which does not seem appropriate nor in keeping with the intention behind the BCBS proposals. Therefore the ABA recommends that the assets and revenue test is applied at the risk customer level, not the consolidated group level.

The ABA agrees with the IIF that the €50b and €200m threshold levels proposed by the BCBS is too conservative and could have adverse consequences on strong investment-grade credits. The ABA recommends these proposed thresholds for SA and FIRB treatment should be revised upwards in line with the IIF recommendations and QIS data.

The IIF submission to the Committee contains a comprehensive discussion (section 5.1) on the proposed RWA approaches for banks and financial institutions. The ABA agrees that the finalisation of the definitions of financial institutions requires careful consideration as financial institutions currently segmented as corporate (such as insurance or funds management institutions) could be materially impacted, particularly here in Australia where there is a significant number of these types of counterparties not externally rated.

Probability of default – clarification of guidance on rating systems

In section 4.1 (Probability of default), the Consultative Document proposes that “Rating systems should be designed in such a way that assignments to rating categories generally remain stable over time and throughout business cycles. Migration from one category to another should generally be due to idiosyncratic or industry-specific changes rather than due to business cycles.” While it is clear that the Committee’s overall intention is to reduce the pro-cyclicality of the regulatory capital requirement, the statement is open to interpretation regarding how this is intended to be achieved.

One interpretation is that the financial ratio criteria used to assign obligors to a rating category should remain stable over time. If so, for individual obligor ratings, there would still be migration across rating grades driven by changes to the obligors financial position due to the increase or decrease in stress associated with the business cycle. That migration however, can be interpreted as being inconsistent with the statement in the Consultative Document that migration across rating categories should not occur systematically as a result of the business cycle. This also begs the question exactly how much risk grade migration (in the sense of what % of the obligors in a risk grade migrate) can be assumed to be idiosyncratic or industry-specific. In particular, some industries are clearly cyclical and hence will always be subject to risk grade migration under adverse business cycle conditions.

An alternative interpretation is that the Committee is requiring the assignment of an obligor to a risk-grade should be calibrated in such a way that the rating seeks to predict the kind of business cycle driven risk-grade migration that sees a counterparty’s financial ratios decline under adverse conditions. It is not clear however, why a risk-grading system operating in this manner should be required to forego risk sensitivity when the same degree of stability in the capital requirement could be better achieved via



other explicitly counter-cyclical mechanisms e.g. by the design and calibration of the expected loss shortfall deduction working in conjunction with the counter-cyclical capital buffer (**CCyB**).

Pro-cyclicality of the capital requirement is a complex topic that interacts with other components of the capital adequacy framework. Any consideration of the stability or risk sensitivity of the rating system should also consider the extent to which the CET1 capital deduction for “expected loss shortfall” and the variable CCyB operates to stabilise the capital requirement across business cycles. It is also useful to distinguish between the kinds of volatility associated with relatively high frequency but low amplitude “business cycles” and the less frequent, but more severe, disruptions to economic activity associated with the “financial cycle”. The ABA notes that financial cycle style disruptions are typically associated with high levels of credit expansion that are also one of the factors considered in choosing to implement the counter cyclical capital buffer. In the absence of greater clarity on these questions it is probable that different banks and supervisors will adopt different interpretations of how rating system stability can and should be implemented.

Credit conversion factor

The ABA agrees with the BCBS’s observation that variances in the treatment of credit conversion factor (**CCF**) are a significant source of variance in credit RWA and supports the principle of setting clearer standards that facilitate greater consistency and comparability of credit RWA.

The ABA believes that application to unique specific product types, such as the current IRB concessions afforded to short term self-liquidating trade related products, should be considered to avoid unintended economic impacts associated with trade finance, particularly between mature and emerging economies.

Double default

The ABA requests that the committee reconsiders the proposed removal of the double default framework from the IRB approach. Other than a reference to its limited use, little detail was provided in the Consultative Document to justify its removal. Double default is not a factor in risk-weight variance, more importantly it is an effective credit risk mitigant which provides the opportunity for effective portfolio management with equal incentive to hedge both poor quality and high quality counterparties. Other benefits include:

- That both obligor and hedge counterparty must default to trigger loss event which is a lower risk event than any substitution approach could measure.
- The allowance for diversification of idiosyncratic risk to hedge providers. Given that asset correlations used in the risk-weight formula measures systemic risk, a lower asset correlation is an appropriate risk sensitive measurement.
- Provision for alternatives to secondary markets which can be difficult to access or expensive, whereby portfolio management using hedging options should provide for risk sensitive capital outcomes.

Implementation timeframe

The ABA requests the Committee sets implementation deadlines that allow the industry sufficient time to implement the required new systems and data collection processes. Coupled with the need to now simultaneously calculate the standardised approach, IRB banks will also face significant operational changes as a result of these proposals.

Many banks rely on third-party vendors to supply the technology systems used to calculate RWA. These vendors will be unlikely to start re-engineering their offerings until the Basel Committee has finalised its standards. The cumulative lead times of vendors (where applicable) and subsequent work by banks to implement the IRB revisions, coupled with the SA, will take substantial time to complete. In light of this, the ABA requests the Committee considers accommodative implementation timeframes.



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Such flexibility would be most welcome given the existing significant program of other interconnected and concurrent regulatory reforms (e.g. FRTB) already scheduled for implementation.

Thank you in advance for your consideration of our comments.

Yours faithfully

A handwritten signature in black ink, reading 'Aidan O'Shaughnessy'.

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