EACB Comments on the Consultative Document of the Basel Committee on Banking Supervision

Capital floors: the design of a framework based on standardised approaches

Brussels, 27th March 2015

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Introduction

The members of the EACB welcome the opportunity to comment on the BCBS proposal for "Capital floors: the design of a framework based on standardised approaches" (SAs).

We understand that work is still very preliminary, however there are a number of aspects that cannot be disregarded before moving forward with the proposal.

All in all, this consultation comes in a moment where the main elements of the capital framework have just been finalised. In addition to redesigned or new capital requirements, numerous innovation have been introduced also in the capital processes of credit institutions and supervisors.

We fear that such proposal could increase legal uncertainty and even discourage banks from providing credit in a moment where financing of the real economy is crucial, as underlined also by the European Commission. In this context institutions need greater stability and consistency of regulation, and should not be driven back to a Basel I approach after regulatory developments that have vastly improved IRB models also under strict supervisory assessment.

Retail banks that apply internal models would be heavily penalised. Indeed, retail banking, which is the least risky activity, benefits from internal models capital allocation and their more accurate availability of historical data for credit risk. Such a proposal would penalise retail banks and the financing of the local economy, especially as regards to SMEs.

Moreover, according to the European legislation, the use IRB approach is scrutinised and has to be approved by the competent supervisors (see Articles 143 and 144 of the CRR). The introduction of floors could suggest that supervisors are not effective in implementing the regulation properly and that a further backstop is necessary. This would call into question the entire regulatory construction based on Basel II and Basel III.

Introducing floors could also exacerbate competitive distortions, for instance between the US Banks and European banks. Via the impact that a floor on credit risk would have on real estate exposures, serious harm may derive for mortgage financing in Europe as opposed to the US. Indeed, according to Moody's almost two thirds of the risk on outstanding mortgage loans are borne by American taxpayers through the federal guaranty on Fannie Mae and Freddy Mac. Therefore, while the floors would have limited effects on American banks and housing financing in the US, they would imply major consequences for European banks and European economy.

Given also the fact that the work of the Basel Committee on the SAs is still under way, and the very preliminary nature of the consultation paper on capital floors, it is difficult to provide a thorough evaluation of the proposal.

In this respect a preliminary deep and comprehensive data collection would be a necessary moment before proceeding with further steps. A QIS exercise should however allow sufficient time to gather significant data, and take into account that the picture may still be not accurate given a yet to be completed review of the SAs. We strongly suggest that a second round of consultation is conducted, once the revision of the SA framework is finalised and further elements on the calibration of the Capital Floors are available.

General remarks

1. Avoid automatic increases of capital requirements due to floors

It is of the utmost importance that the proposal for capital floors in connection to a revised framework for the SAs, does not turn into an **automatic** increase of capital requirements. This risk is concrete, especially in consideration of the approach undertaken by the Committee in the proposed review of the SA for credit risk. If it is to be carried out, the exercise should aim primarily at an harmonisation of the IRB refraining from imposing further capital constraints to institutions.

The introduction of floors modelled as an automatic mechanism based on the SA approaches will have relevant implications on the incentive for banks to develop risk sensitive IRB models, that play instead a crucial role even for managerial purposes. The link with the SA approaches should only serve as a tool to **identify potential outliers** that should then be further analysed by competent supervisors.

Before implementing a set of permanent Capital floors, it is crucial to demonstrate if and where there are specific areas where undercapitalization is witnessed. On the other hand, for all those areas where there is no evidence of undercapitalization, any proposed floor should not lead to increased capital levels.

The implied assumption that lower internal model outcomes are evidence of capital insufficiency vis a vis the SAs is at least doubtful:

a) Reduced RWAs for an IRB bank at any time may have been an appropriate measure of the actual risk and/or changing portfolio composition. The actual surplus or shortage of capital cannot be inferred without looking at the real portfolio or asset class and its underlying risks. The business model, the knowledge of its customer base, the quality of controls of the institution and its risk management, the jurisdiction, the supervisory practices, the portfolio segment, and the market-specific mitigating factors could turn into a reduced risk profile where at first glance it could seem a homogeneous asset class or portfolio across the industry.
b) As long as the SA framework does not allow full national calibration and includes limited loss predicting risk drivers, the SA framework does not become truly more risk sensitive and does not recognise the significant differences in local risk profiles. A risk sensitive IRB framework cannot be compared with a non-risk sensitive SA framework by imposing floors. The proposal does not seem to go in the direction of enhancing comparability in terms of comparing risk profiles and ensuring that similar profiles determine the allocation of similar capital levels.

Lower risk profiles, that are acknowledged in the risk sensitive IRB framework will be negatively affected by non-risk sensitive floors, with relevant and vast consequences for the real economy. Such floors will disregard IRB-based information and are not in the interest of stakeholders when comparing banks. Stakeholders might think they are assessing a risk sensitive metric, while they are not in fact. A stronger solution would be to disclose both values, complemented with uniform Pillar 3 disclosures.

As already recalled, according to the European legislation, the use IRB approach is scrutinised and has to be approved by the competent supervisors (see Articles 143 and 144 of the CRR). The introduction of floors could suggest that supervisors are not effective in implementing the regulation properly and that a further backstop is necessary. This would call into question the entire regulatory construction based on Basel II and Basel III.

In conclusion, the use of floors should only be a tool at disposal of the supervisor under a Pillar 2 umbrella, and with transparent and justified application.

2. A strengthened regulatory environment

Following the vast regulatory wave that has fundamentally reshaped capital requirements across all jurisdictions, a comprehensive evaluation of the measures introduced would be needed before proceeding to an overall review and recalibration of the capital framework.

However, such an exercise would be possible only after having allowed the measures designed to perform their effects on the institutions and the economy.

In this context, among the measures contributing to overall higher capital requirements we can mention the numerous capital buffers introduced (capital conservation, countercyclical, G-SII and O-SII), ongoing discussion at the global level on a total loss absorbency capacity buffer based on risk weighted assets, and, although not based on RWAs, the definition of a minimum requirement of eligible liabilities (MREL) for resolution purposes in the EU. Moreover, the additional Pillar 2 requirements stemming from the supervisory review and evaluation process (SREP) constitute a further element of safeguard against potentially low levels of capital.

In addition, we have also witnessed the introduction of the leverage ratio as a minimum non risk sensitive backstop. The leverage ratio will indeed address model risk, limit undue optimism in internal models, and act against low levels of capital that may derive from model based RWAs.

Before proceeding to further reviews of the framework there is a decisive need to allow regulation to stabilise, to ascertain and evaluate the full potential and impacts of tools introduced and to give manner to institutions to proceed to a meaningful and effective implementation of the numerous elements already designed.

3. *Impact on the business*

Although no calibration is yet provided in the consultative document, we are very concerned by the possible significant combined impacts of this proposal and the SA review which could potentially negatively affect the banking landscape for both our banks' clients and for the banking industry. Also, too restrictive floors would lead to a distorted and risk-insensitive allocation of capital (shift from low-risk towards high-risk assets and clients), with detrimental effect on economic growth in the European Union.

Retail banks that apply internal models would be heavily penalised. Indeed, retail banking, which is the least risky activity, benefits from internal models capital allocation and their more accurate availability of historical data for credit risk. Such a proposal would penalise retail banks and the financing of the local economy, especially as regards to SMEs.

The combination of SA floors and the leverage ratio may make low risk portfolios economically unviable given that returns will no longer be commensurate with risk.

The use of the SA also as a floor for IRB models in connection with the introduction of the leverage ratio will limit both volumes and risk, leaving open the question on who takes financial risk and provides the credit that is decisive to support growth.

This could lead a push towards the shadow-banking sector and constrain lending, especially in the case of mortgage loans, trade and commodity finance, credit card exposures and certain investment grade portfolios. Rather than applying crude capital measures, it would be preferable to ensure individual bank capital is adequate at all times through Pillar 2 and regulatory stress testing.

If risk weights are floored by a non-risk sensitive Capital Floor, relevant limits would result for the incentive to strictly structure a facility and get collateral. This could eventually lead to banks' balances being loaded with higher risk loans, potentially posing a serious threat for financial stability, as capital does not outweigh the true risks anymore. So such a floor limits the incentive model of clean lending versus borrowing base versus transactional finance. The use test becomes a failure, i.e. the Pillar 1 capital results do not support a proper risk management function and effective deal structuring anymore.

In this respect a preliminary deep and comprehensive data collection would be a necessary moment before proceeding with further steps. A QIS exercise should however allow sufficient time to gather significant data, and take into account that the picture may still be not accurate given a yet to be completed review of the SAs. We strongly suggest that a second round of consultation is conducted, once the revision of the SA framework is finalised and further elements on the calibration of the Capital Floors are available.

4. *Impact on the management*

The introduction of floors modelled as an automatic mechanism based on the SA approaches will have relevant implications on the incentive for banks to develop risk sensitive IRB models, that play instead a crucial role even for managerial purposes.

We feel that the introduction of floors based on the SAs in combination with leverage requirements, will result in a substantial reduction of the overall risk sensitivity of the framework. This would be hard to understand, especially in light of the investments undertaken in the implementation of internal models, under strict scrutiny and approval of supervisors, to achieve increased sensitivity.

A key aspect of IRB models is that they are much more sensitive to the specific risks in banks' portfolios, and to the variety of risk factors and their predictive power even within the same asset class.

The introduction of floored capital based on SAs, far from communicating the individual bank's distance from regulatory requirements, may instead conceal the actual risk profile of institutions. Moreover, if the combined effect of capital floors and the proposed review of SAs imposes the latter as the binding constraint, incentives to the use of (or migration to) IRB models would be dramatically reduced, with clear effects on risk sensitivity. This would also reduce incentives to constantly develop, improve and regularly validate IRB models.

The use test requirement which puts the internal estimates used for IRB at the centre of risk management and decision making, coupled with a more extensive supervisory activity of control and regular benchmarking exercises, are already powerful tools to increase the comparability of IRB models and set the right incentives. It has to be noted that regulatory benchmarking is still too recent, as it will inform supervisory action it will reveal its full harmonisation potential in the future. In this context, supervisors have also been conducting stress testing exercises whose role, in harmonising and recalibrating institutions' risks, should not be overlooked.

The IRB approach is a very important metric within the Basel III suite, and internal models gave an additional boost to solid risk management. If further strengthening of the IRB is needed, a different approach should be pursued. Complementary to IRB there are already several metrics (e.g. Leverage Ratio), which together from a comprehensive set of metrics for supervisors and other stakeholders. From this angle there is no need for Capital Floors.

5. Capital floors as a backstop against IRB

The Committee envisages Capital Floors as a backstop regarding potential flaws in the IRB framework, however these potential flaws should firstly be identified. Thereafter, if demonstrated, they should be addressed by further strengthening the IRB framework.

In 2014 IIF already published an IRB study including several recommendations in this direction. Also – very recently – EBA published a discussion paper, that wishes to increase transparency and should ensure supervisory consistency. We believe that the full picture of these positive developments should be examined by the Committee.

Instead of proposing floors, certain IRB elements could be addressed to further strengthen the IRB framework and reduce the variability of RWA's. For instance:

- When authorising IRB models:

Clear rules could be set to establish cases where data is of sufficient quality and quantity to build a proper internal model. If too little data is available (low data portfolios) solid alternatives could be proposed (FIRB or further standardization), CCF estimation for off balance exposures, etc.

- When building models:

More granular rules could be provided for the definition of default, days past due, levels of model conservatism, how to apply downturn (also if downturn data is missing), how to set discount rates for LGD models.

- When model results adequate:

Set clear rules for minimum back-testing results.

After such improvements to IRB, and taking into account the current tools in the hands of supervisors has to ensure proper usage of these models, all stakeholders could embrace the IRB framework in full.

Q.1 Assuming the respective floors were calibrated to achieve the same level of required capital, what are your views on the relative merits of a risk category-based floors and an aggregate RWA based floor? What are your views on a floor based on exposure class?

The Committee indicates that the calibration of one of the options (i.e. a risk-category based floor or an aggregate RWA floor) shall be done in a way to produce similar impacts on average. However, it is hard for institutions to ponder on a preferred option as there is not enough information regarding calibration possibilities and mechanics.

Overall, it seems difficult to separate discussions from the calibration from the design of possible tools. In this respect, it seems that the Committee might consider to use a Basel I calibration. However, due to the important evolutions occurred in the regulatory and financial landscape, this would have extremely negative impacts for the RWAs of European banks, leading to an exponential growth of RWAs and ultimately of capital.

In addition, the mentioned floor based on exposure class is too undefined and difficult to envisage under the circumstances. However, in general a floor at a granular asset class level, does not seem to provide any additional benefit that is not already covered by the leverage ratio, and may be far from the objective of maintaining a simple approach.

With regard to a single aggregate floor, while it could have some advantages on risk category based ones, it should not however exclude in principle that calibration is done by taking into account the different elements and aspects of the various risk category (market risk, credit risk and operational risk).

Overall, we find it extremely challenging to provide input on the preferred level of aggregation, especially considering even the lack of detail on the final SAs.

Q.2 What are your views on the relative merits of the two options for adjusting for differences in the treatment of provisioning for credit risk?

Also in this respect, the choice of a preferred option can hardly abstract from the calibration and mechanics of the floor, otherwise it is very difficult to assess the impacts of the two options and reach an informed conclusion. The Committee should provide well rounded examples on possible mechanics, and on these basis collect data from institutions.

In addition, the implications of the changes in the impairment regime for regulatory capital standards are unknown, and the Committee is currently revisiting the expected loss (EL) shortfall/excess computation. The final results may influence the discussions on the proposed options.

At a general level, it can be noted that currently under the standardized approach the risk weights are inclusive of both EL and unexpected losses (UL), and firms are allowed to include general provisions in Tier 2 to cover EL. The Committee requires instead that, under IRB, EL are calculated and the portion of EL that is not covered by provisions is capitalised. It would seem then that for Option 1, given that the IRB function currently does not correct to include EL, this could be capitalized into an RWA equivalent.

Thus, overall Option 1 seems to be simpler, since it requires no assumption on the size of standardized EL, easier to induce harmonization, and it would have room to distinguish between provisioning adjustments made to CET1 and Tier 2 capital.

Option 2 instead, while it might will be easier to be monitored by supervisors, it also has some important disadvantages as it does not take into account capital buffers, and it requires that provisions are converted into a RWA equivalent. This poses the fundamental question on what conversion ratio will be applied. Moreover, Option 2 seems inconsistent with the proposed review of the SA which envisages the use of the CET1 ratio. In fact, if excess provisions were used to adjust RWA, the CET1 ratio would change accordingly posing an incentive to accumulate more Tier 2 resources.

Q.3 Do you have any other comments regarding the design of the capital floor?
