March 27, 2015

Mr. William Coen
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2, CH-4002 Basel
Switzerland

Dear Mr. Coen,

The Institute of International Finance (IIF), the Global Financial Markets Association (GFMA), the International Swaps and Derivatives Association (ISDA), and The Commercial Real Estate Finance Council (CREFC; collectively, "the Associations") represent the largest participants in national and global banking and financial markets.[1] The Associations appreciate this opportunity to comment on the December 2014 Consultative Document issued by the Basel Committee on Banking Supervision (BCBS; "the Committee"), named "Capital Floors: the design of a framework based on standardized approaches" ("the Consultation Paper" (CP)).

The Associations support the work of the Committee and specifically of the Task Force for Simplicity and Comparability (TFSC) aimed at conducting a comprehensive review of the capital framework and its overall calibration and taking stock of the multiple changes thereto in the course of the past 5 years. The Associations are equally supportive of the Committee's goal to remove undue complexity and improve the comparability of banks' capital requirements. The Joint Associations welcome the opportunity to contribute to the discussion on capital floors.

In our view, a comprehensive and holistic review of all components of the Committee's work to improve the prudential framework under the financial reform agenda is paramount. Such a review is appropriate to assess the extent to which recently implemented reforms balance risk-sensitivity, comparability and simplicity and align with regulatory objectives, but also to recalibrate overall capital, and loss absorbency and the acceptable level of leverage.

The aforementioned review should ideally also analyze possible impacts on financial stability as well as on the ability of the banking sector to provide credit and other vital services to the real economy. In this regard, it is essential to recognize that at this stage many pieces of the regulatory capital framework are still being developed, and therefore, evaluating their overall impact on capital as well as on portfolios and business models, will prove rather challenging.

[1] The Associations collectively represent financial institutions accounting for a substantial majority of global banking and financial assets. Descriptions of the Associations are provided in Appendix 2 to this letter.

As an example, we draw your attention to the case of credit risk, where there is uncertainty surrounding both the internal model approach and the standardized approach (SA) for credit risk. Lending is a core function of banking which directly affects the real economy. Therefore, decisions involving credit risk capital should preferably be made after careful consideration of all angles, as well as a full analysis of good quality data. This will ultimately benefit the G20 goals more than a time bound exercise finished in the space of only one year.

While the Associations fully support the goal of addressing shortcomings in elements of the regulatory capital framework and in particular internal modeling practices, we recommend that this effort does not result in a rewrite or overhaul of Basel III or any of its underlying standards. Basel III was the culmination of a lengthy and thorough thought process and has substantially enhanced risk-capital coverage and associated risk management practices as well as the quality and quantity of capital. Banks, supervisors and regulators across the globe are phasing in or on the verge of implementing Basel III at significant cost and effort, all of which require a stable framework.

Similarly, the combined effect of all the measures already taken to remedy the perceived weaknesses of the capital framework, and in particular of the internal model based approaches, is only partly known. Additional, complementary solutions to overcome some of these shortcomings may not yet be fully implemented or are in various stages of development by regulators, supervisors and industry. We refer in particular to the work undertaken by the Committee,[2] and by regional or local authorities such as the European Banking Authority (EBA).[3] In its report issued in November 2014, the IIF Risk-Weighted Asset (RWA) Task Force (IRTF)[4] contributed to these efforts by undertaking a multi-pronged analysis covering all aspects of internal modeling approaches and RWA generation culminating in the formulation of detailed recommendations for improvement and harmonization.

The Associations are therefore of the view that a decision on new capital floors should ideally be adopted at a stage where the Committee is fully able to take account of these remedial actions. Furthermore, we are concerned that capital floors are inconsistent with the aims of risk sensitivity, simplicity and comparability.

First, in contrast to initiatives such as those proposed by the Committee and by European authorities to reduce RWA variability and improve transparency and benchmarking, the incorporation of capital floors in internal model based capital approaches does not directly address the root cause of the problems that undermine confidence in models. A capital floor based on SAs should preferably be pursued as the last step in the update of the framework and only if the concerns identified by the consultation paper are not addressed by such other initiatives that address the root cause of the problem.

Second, capital floors, especially if and when set at high calibration levels have the potential to undermine risk sensitivity, and create adverse incentives that conflict with the promotion of improved and more advanced risk management practices. In particular, if a floor is binding, any incentive to further improve risk management could be distorted and at that stage

[2] BCBS, *Reducing excessive variability in banks' regulatory capital ratios, A report to the G20* (November 2014).
[3] EBA, *Discussion Paper on the future of the IRB Approach* (EBA/DP/2015/01) (March 2015).
[4] IIF, *The IIF Risk Weighted Assets Task Force (IRTF) Final Report* (November 2014).

a bank could rightly question the added value of supervisory-validated internal models. To provide for an effective intermediation mechanism, banks must at all times be able to assess and price risk correctly, and thus find an adequate balance between risk and return, whereby the latter is based on a capital cost that is commensurate with this risk.

Third, we believe capital floors have the potential to compromise, rather than support the goals of simplicity and comparability. True comparability is unlikely to be fully achieved given that capital floors will affect banks in materially different ways and due to the lack of recognition of the quality of a bank's risk management. The nature of the client-bank relationship and private information are also key parameters that may be overlooked in a standardized approach. It also cannot be ruled out that not all banks will be bound by the same ratio or underlying standards, due to divergences in national implementation. This increases complexity for investors seeking to understand a bank's risk portfolio and for the banks seeking to allocate capital effectively. We further note that the actual computation of the proposed floors and adjustments to internal model approaches to realize a basis for fair comparison embeds a new layer of complexity.

Lastly, we believe that the regulatory capital requirement is meant to make an individual bank more resilient to shocks as regulatory capital is primarily a micro-prudential tool. If the regulatory capital framework is focused on the adequate capitalization for the industry as a whole, it may lead to a scenario where it becomes unclear to what extent an individual bank will turn out to be well capitalized under severe stress.

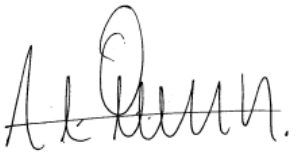
Irrespective of the above, the Associations recognize that shortcomings in internal model approaches should be addressed, that comparability and transparency of RWA should be enhanced and capital robustness reinforced in some specific areas. However, rather than a "quick fix" solution, we believe that alternative, targeted solutions could be explored to preserve many benefits of internal models while addressing undesired shortcomings. As an example, the introduction of a positive incentive mechanism to improve models deemed inadequate should be considered. Such alternatives may serve the Committee's objectives equally without generating the issues we are outlining throughout this paper. Such structures that would be applied by supervisors across the globe in a consistent manner could complement the regulatory tools and measures that are already being developed in the context of the various work streams aimed at harmonizing and improving model standards.

The present Consultation Paper delinks the design concept of the capital floors from its associated calibration, presumably awaiting Quantitative Impact Study (QIS) results and final revisions to the risk-weighting frameworks. However, for the industry to take a firm view on the design of capital floors (i.e. gauge their impacts and possible unintended consequences) information on calibration, or at least calibration intentions, is absolutely needed as the two issues are intrinsically linked. Calibration decisions could result in practice in a conceptual shift of the capital framework away from internal model approaches and internal risk views being de facto divorced from regulatory capital. It is therefore a fundamental question that has to be viewed on par with objectives and design issues. Our comments in this letter should therefore not be misconstrued as reflecting a final view but rather as a contribution to the debate given the information that has been made available to us at this stage.

In case the Basel Committee determines that, notwithstanding existing and new remedies, capital floors are necessary to restore confidence in bank capital adequacy, we would urge that the points listed in this letter are taken into account when defining the optimal floor design and the required calibration level. While all member banks agree that the current uncertainties surrounding the capital approaches and the exact computation of floors render a formal industry position premature at this stage, a majority of banks has tentatively indicated a preference for an aggregate floor. In Section V we will outline a number of points on which we request further clarification.

The Associations are aware that a second consultation may be published later this year, which will contain more detailed proposals. If more clarity is also obtained on developments on both internal model and the new standardized approaches, the Associations stand ready to contribute to this second consultation with comprehensive views and technical foundation. We believe that a second phase QIS focused on the full calibration of the capital framework is warranted for a fuller understanding of the ramifications of all capital and related proposals taken together. Knock-on effects of changes in one standard on other standards (e.g. changes in Credit Conversion Factors (CCFs)) could then also be integrated and analyzed more precisely.

Sincerely,



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At this moment in time, both the level of aggregation and the design of the capital floor(s) are still uncertain. The level of uncertainty at this stage, although accepted by the industry as unavoidable given that the QIS results are needed to decide on those key points, raises concerns about possible scenarios in which the risk sensitivity of the regulatory capital framework would be severely compromised.

Our comments below should therefore be read and understood as reflecting the scenario in which floors would constitute a material override of internal model outcomes.

Section I – Role and Objectives of Capital Floors and the Leverage Ratio (Paragraphs 11-15)

1 The Associations support the view that a capital framework should be in place that is (1) risk sensitive minimizing undesirable incentives that may distort market outcomes; (2) simple and produces consistent outcomes across banks; and (3) robust in the face of uncertainty about the future. The Associations question whether a system based on constraining capital floors can accomplish these goals.

2 From a design perspective, the Associations are concerned that the attempt to use a risk weighted floor to address all three concerns listed in paragraph 13 of the Consultative Document will result in an outcome that does not fully meet those expectations while adding to the complexity of the framework. Many or all perceived shortcomings of internal model approaches are already being addressed by way of alternative new or existing measures and regulatory processes. Appendix I outlines for each of the objectives listed in paragraphs 11-15 of the Consultation Paper which processes are equipped to deal with the same issue. More importantly these are not expected to bring about the same unintended consequences that the industry foresees with both the leverage ratio and capital floors, if either or both of these are calibrated at levels that would present a material override of internal models outcomes.

3 We refer specifically to the important role of both regulatory stress testing and Pillar 2 to ensure that capital is never too low at an idiosyncratic level, and in addition to the role of capital buffers to cope with macro-prudential concerns. We also refer to solutions being developed at various levels within the Committee and at regional levels to reduce RWA variance by harmonizing model approaches and key definitions and by further fine-tuning benchmarking exercises.

4 As we are seeing in the securitization markets, if historical losses and capital requirements are materially different, and this material difference is not justified by trend breaches, negative outlooks or other relevant forward looking factors, the business case becomes unviable for either banks or their customers or both and the supply/demand balance becomes structurally distorted.

5 The calibration of the leverage ratio addresses the risk of unexpectedly large losses in low-RWA portfolios. Some regulators believe that this may still prove ineffective. The combination of SA floors and the leverage ratio may however make low risk portfolios economically unviable given that returns will no longer be commensurate with risk. This could lead to a push towards the shadow-banking sector and constrain lending, especially in the case of mortgage loans, 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 processes within which regulatory stress testing can play a contributing role. The Associations also note that some jurisdictions have already proposed or implemented floors on the minimum internal model generated risk weight for exposures of particular concern. The extent to which such existing floors at granular levels would interact with the capital floor being proposed in this consultation is therefore unclear. This additional layering could inadvertently add undue complexity to the capital framework.

6 The Associations further believe that the redesign of the market risk framework in the FRTB with the explicit objective of having a credible fallback by narrowing the gap between the IMA and SA, seriously calls into question whether any further floor is needed at all for market risk. After all, the SA for market risk is expected to operate as a fall back scenario that would allow regulators to switch off internal model calculations and prescribe SA methodology in the event the internal model does not adequately perform.

7 One of the objectives of capital floors stated by the BCBS is the so-called "incentive-compatibility" issue. The Associations believe that adherence to the use test requirements and -increasingly intrusive- supervision already deals with incentive-compatibility issues (if any). Models enable senior management to measure and adequately and timely manage portfolio risks; senior management naturally requests to be informed at all times about (negative trends in) expected and unexpected losses and their effect on capital and profitability. "Gaming the system" would merely provide a very short-term benefit.

8 We further stress that lower RWA since the introduction of Basel II was a partly expected outcome of the transition to more sophisticated measurement. It is likely to have been caused by banks' increased risk awareness due to insights procured by their internal models and due to the experiences of the crisis, which resulted in changed portfolio compositions and selective deleveraging. In times of crisis RWA can be expected to decrease as well in view of unexpected loss estimates (reflected in RWA) turning into expected loss estimates (as reflected in provisions). Furthermore, by now supervisors have managed to reverse much, if not all, of the undesirable impacts with existing tools.

9 More generally, we propose to differentiate between two related, but not entirely similar goals; the need for more comparability and the need for more capital in the industry or for certain types of risk or exposures. Both can be resolved by way of alternative solutions, but not necessarily in the same manner.

The notion of "Prudent Level of Capital"

10 The Committee states it strives for a "prudent level of capital." We strongly support this goal so long as it translates into an "accurate measure of risk." A wider debate is warranted on the required level of bank capital and where and how confidence intervals and tolerance levels for bank failure should be set.

11 In this context, it is equally important to determine (and consistently apply) the level at which possible corrective adjustments to capital, if and when needed, should be made: at the level of the denominator of the capital ratio or at the level of the numerator of the capital ratio (i.e. by way of Pillar 1 or Pillar 2 adjustments, minimum ratio requirements, or capital buffers).

This influences decisions on the floor design. There is currently a wide range of practice in how supervisors pursue these adjustments in their individual jurisdictions; the consistency and comparability of these supervisory interventions should therefore be revisited in light of the decision on revised capital floors.

12 In line with expressed industry views[5] we prefer that conservative corrections - if necessary - be added at the end of the process to the numerator of the capital ratio, or by way of additional own funds requirements. The primary focus of Pillar 1 measurement should be to establish the correct relative risk ranking of different types of exposure. This approach would support the BCBS's objectives of transparency and comparability: (i) by allowing for a better comparison of the real increase in the capital ratio, and (ii) by headlining a solvency ratio based on internal models.

13 Once these risk relativities are established, the desired level of prudence can be best addressed by other means (e.g. by way of adjustments to the numerator informed by stress testing and Pillar 2 considerations), which have the added benefit of not jeopardizing granular risk rank ordering and capital differentiation.

[5] IIF and ISDA *Response to BCBS consultative document Balancing Risk Sensitivity, Simplicity and Comparability* (October 2013); IIF, *Risk Weighted Assets Task Force Final Report* (November 2014).

Section II – Concerns Related to Basel Timelines

I – The full impact of post-crisis changes is not yet felt

14 Even though at present, post crisis changes in regulation, bank and supervisory practices are only beginning to phase in, their impact should preferably be factored in discussions about the future of the capital framework in general, and about capital floors in particular.

15 To illustrate the multiple changes that have been implemented in the post-crisis era we list in Box 1 elements associated with internal models and loss absorption capacity. Their respective transitions render a final impact analysis possible only later in this decade.

Box 1: Changes implemented post-crisis era to remedy shortcoming found/perceived in capital requirements derived from internal models	
Actioned by:	**Actions:**
Regulators and other standard setters:	• Substantially increased the quantity and quality of capital • Put in place various capital buffers to cope with cyclical, systemic or other macro-prudential and idiosyncratic concerns • Added new risk categories against which capital must be held • Provided a sound basis for the recovery and resolution of cross-border banks and assured that adequate loss-absorbing capacity is available in a resolution of a bank • Revised or are in the process of revising all capital standards for internal model approaches • Requested alternative modeling approaches and enhanced model standards for the measurement of certain risk categories • Reinforced Pillar 2 guidance and Supervisory Review and Evaluation Process (SREP) processes • Implemented annual regulatory stress testing exercises • Implemented bi-annual benchmarking exercises • Revised reporting and disclosure standards targeted at greater transparency of individual bank risks and related RWA • Revised valuation and provisioning standards • Engaged in a full analysis of RWA and model choice harmonization
Supervisors:	• Performed asset quality reviews and critically assessed internal model outcomes and provisioning levels to detect idiosyncratic problems • Frequently intervene at various levels in the model cycle by way of floors, imposition of assumptions and modeling choices in individual models; further, heightened the barrier for model approval Since this is done on a case-by-case basis, many initiatives are presently underway at global, regional, and local levels to synchronize those interferences, develop common supervisory standards, and create best practices' supervision • Undertake analyses on modeling choices with a view to reducing outliers and unwarranted RWA variance
Banks:	• Improved and expanded internal stress testing practices

	• Continued to improve, monitor and back test internal models, enhanced internal model governance and institutionalized model risk management • Increasingly joined data pooling, and benchmarking efforts to complement internal data and to benchmark model outcomes against those of peers[6] • Built in conservatism in the form of margins of prudence, floors or other adjustments and, where possible, cover data deficiencies by way of the use of external data, industry data pooling, and/or supervised extrapolation techniques • Focus more on tail risk issues • Initiated the debate on RWA variance by forming a group of 43 banks that identified the drivers of RWA variance, assessed their impacts and issued around 100 detailed recommendations to reduce RWA variance with a view to retaining only desirable RWA variance in the system

II – Pending Basel standards make the picture incomplete

16 The Committee's stated intention is to finalize the final capital floor standard before the end of 2015, noted in paragraph 7 of the Consultation Paper. However, the review of the overall capital framework conducted by the BCBS TFSC remains ongoing.

17 The present consultation on capital floors coincides with the work being undertaken in various regulatory[7] capital work streams as outlined in Box 2 below.

Box 2: Work currently being undertaken in various regulatory capital work streams	
1	The finalization of the Fundamental Review of the Trading Book (FRTB) including the SA for Market Risk
2	The QIS exercises and finalization of the SA for Credit Risk
3	The finalization of the new SA for Operational Risk
4	The review of the Advanced Measurement Approach (AMA) for Operational Risk
5	New Interest Rate Risk in the Banking Book (IRRBB)/ Credit Spread Risk in the Banking Book (CSRBB) standards
6	The QIS and final standard for Total Loss Absorbing Capacity (TLAC)
7	The recalibration of the Leverage Ratio
8	The revision of the Basel requirements related to sovereign debt exposures
9	The possible incorporation of the criteria of Simple, Transparent and Comparable Securitizations in the securitization capital framework
10	A reconsideration, at various regulatory levels, of Pillar 2 aimed at strengthening its mandate to identify and mitigate residual risks

[6] For example, Global Association of Risk Professionals (GARP), Credit Benchmark, and PECDC (now GDC).
[7] We refer to work undertaken by the BCBS (cf. its work program for 2015 and 2016), the Financial Stability Board (FSB), the International Organization of Securities Commissions (IOSCO), and by regulatory authorities at local or regional levels.

11	The recently announced work stream assessing the interaction between regulatory Stress Testing and Pillar 1
12	The discussion on the treatment of Expected Loss and the Expected Loss shortfall/excess calculation as impacted by the new impairment/Expected Credit Losses (ECL) regime
13	The work streams tackling the reduction of RWA variance
14	The work streams considering the establishment of exposure class and/or risk parameter floors
15	The work streams enhancing the transparency of banks' RWA and internal models (e.g. the Enhanced Disclosure Task Force (EDTF); Pillar 3)
16	(Although presumed to bear only a minor impact), the review of asset valuation practices potentially altering the exposure values used in capital standards
17	Other initiatives deployed by the TFSC

18 Elements listed in Box 2 are fairly characterized as "moving targets" making it difficult to judge whether the proposed capital floors based on SAs are appropriate until all work streams have come to a final conclusion and until the final SAs for all risk categories are disclosed.

19 In order to avoid unintended consequences or conflicting incentives, the interaction between various new and existing components and pillars of the final capital framework should be properly sequenced[8] to create a well-balanced, holistic final outcome. It is also vital to ensure that terminology and concepts are consistently applied across regulations. Similarly, an additional standardized floor could only cause additional complications, as the leverage backstop is already more than adequate for most low risk products. It is important to fully review the interplay of different measures impacting bank business lines, and to mitigate any overlap or conflicting message derived from different regulatory measures. The wide range of interventions in capital applied through these different measures makes it difficult for banks to manage and monitor regulatory compliance and pricing of products at the individual business lines. In addition, the centralized risk and funding functions will find allocation and pricing of capital and funding more challenging.

20 The final calibration of both the SAs and internal model approaches, and of capital floors, should equally take a detailed account of systemic risk buffers, capital conservation buffers, Global Systemically Important Bank (G-SIB) buffers, and countercyclical buffers. The interaction between the leverage ratio, TLAC, and the capital floors should equally be part of this comprehensive analysis when assessing the floor design and the choice between risk-category based floors and an aggregate RWA floor.

21 Furthermore, while the Associations are supportive of the planned QIS exercises, they observe that there are limitations to the quality of data that can be delivered by banks in a short time span and before IT development has taken place. As an example, corporate and bank ratio information (as requested in the new SA for credit risk) may or may not be available in systems, but data extraction requires extensive coding and IT development. In addition, for ongoing QIS exercises, it is important that QIS instructions and FAQs are published by the Basel Committee

[8] The phased approach proposed by the EBA starting with the definition of default and then building on this to address other inconsistencies in the measurement of risk estimates is an example of the kind of sequencing recommended to fully meet the Committee's objectives.

before the reporting date of the QIS to ensure adequate quality of the information provided by the participating banks. Otherwise, conclusions drawn for both new and altered elements in internal model approaches and new SAs could lead to a capital floor premised on unreliable data and wide-ranging assumptions resulting in unfounded conclusions.

22 In conclusion, it is not clear to the Associations how the different components will complement the Basel Committee's aims. We recommend a comprehensive review of elements listed in Box 2 taking account of the elements listed in Box 1 and whereby the review of current capital floors comes last. Sufficient time must be built in to conduct, and subsequently conclude on, the full review of bank capital requirements.

III – Global economies are on a critical path to economic growth

23 Global economic conditions of many countries remain depressed and others are headed for stagnation at best. Concurrently, central bank policy is still expansionary. Struggling economies would benefit from increased private investments that are not putting a further burden on the already stressed fiscal situation of these countries. Depending on the ultimate calibration choice, a new capital floor could lead to significant increases in the capital requirements for real economy assets such as corporate and retail exposures and by extension negatively affect intermediation of credit through banks to the private sector.

24 Well-functioning capital markets with sufficient breadth and depth are equally critical for future economic growth; banks acting as market makers are key in bridging diverse end-user requirements, including time preferences, investment mandates and risk appetites, of investors (retail and institutional) and users of capital (corporates and consumers). They contribute to allocating capital to the most efficient investments within the economy and providing mechanisms for saving, risk pooling and management. A market risk standardized approach floor will likely have important behavior implications on market making, and therefore on capital market efficiency, product pricing and available liquidity for end-users. This should be analyzed in full, and put in the context of already existing concerns about reduced market liquidity.

25 A rushed increase in capital requirements for this particular sector would only exacerbate the current stress; we thus urge thoughtful consideration of timing ideally in a state where conditions have normalized and banks have fully absorbed the effects of Basel III. Reducing reliance on bank credit intermediation is a long-term goal, which will not be realized overnight and banks will need to retain a key market making and risk-shifting role for capital markets to function properly. Long implementation periods may not suffice to minimize the possibility of shocks in the system or credit squeezes since under market pressure, banks will often need to front-run new rules as soon as they are known.

IV – Industry proposals aimed at accommodating a fully informed decision making process and smooth transition

26 For the reasons stated above, we propose the following:

27 *First*, to avoid governance and transparency issues due to multiple changes in capital standards, we propose to keep the current capital floors in place until an assessment of the effects of such changes can be fully undertaken. This would obviate the need for recurrent

recalibration due to subsequent changes to either internal models or SAs, and to internal bank governance processes. The floor imposed by the Leverage Ratio will be a permanent feature of the revised capital adequacy framework, which further reduces the need to introduce a risk-weighted floor. We recommend that any decisions on the capital floor related to both design and calibration at the very least be delayed until the calibration of the leverage ratio has been finalized.

28 Efforts to reduce RWA variance and to enhance disclosure and benchmarking are on a critical path, and their end result could and should influence decision making in this area. Consideration of a capital floor before this work has been finalized, undermines the objectives of any ongoing work to review and improve internal approaches.

29 We strongly believe that benchmarking will show materially lower variance if the (approx. 100) detailed recommendations of the IRTF[9] on harmonization of modeling approaches and far-reaching transparency are implemented and supported by similar efforts by the Basel Committee and at regional regulatory levels. The industry has shown its willingness to contribute to this process and stands ready to pursue further analysis to this end.

30 In case regulators cannot endorse such a delay, an alternative could be the establishment of transitional floors rather than permanent floors and the insertion of a sunset clause (or at a minimum a regular reviewing process) on the calibration of different capital approaches and the interrelationship between them. A review of the accuracy of assumptions and a reconsideration of the adequacy of capital framework seems warranted given the knock on effect of capital calibration on TLAC, and the Committee's intent to relate the leverage ratio calibration to that of the capital ratio.

31 *Second*, in line with our proposal to perform a phased QIS, we recommend a phased decision making process on areas for which the Basel Committee wishes to put additional measures in place. This phased approach could be based on (1) prioritization of areas which are deemed most pressing by the Basel Committee, and (2) data availability.

32 With this approach, the industry stands ready to provide empirical support for the Committee's analysis. Once the problem areas of capitalization are identified and solutions are crafted, and once the other Basel III reforms have been implemented long enough to assess their impact (including the leverage ratio as a risk insensitive approach that floors capital requirements), it would then be appropriate to determine how a revised SA or other tools can be used to ensure greater and true comparability of RWAs and enhanced financial stability.

33 *Third*, we encourage that sufficient time be provided for the implementation of changes to the capital framework, whether in the form of harmonization of model approaches, altered internal model approaches or capital floors, and that appropriate grandfathering provisions are included taking full account of (1) the substantive IT development and data extraction work that the implementation of a dual capital reporting and computation system, entirely new capital

[9] IIF, *IRTF Final Report*, Credit Risk Recommendations for Harmonization, 195-227, and Market Risk Recommendations for Harmonization, 247-252.

approaches, and the streamlining between internal model approaches and SAs entails; and (2) the potential implications for the economic viability and ensuing re-pricing of certain portfolios.

34 *Four*, to support internal bank governance processes, the Associations also advise that the Committee publishes clear timelines based on realistic assumptions of completion of all of the above mentioned areas that could ultimately affect required bank capital. Milestones should be logically ordered to reflect their interaction.

35 Long term uncertainty remains a fundamental concern underpinning capital regulation and business strategy. Revised capital floors will influence decisions related to capital management, portfolio strategy and long term commitments. For instance, banks have to price long-term products, (e.g. mortgages with interest rates 10-15 years fixed) and then also have to factor in the capital cost. If the capital requirements change drastically, banks cannot adjust the interest rate charged to the client. With the uncertainty surrounding the floor proposal, banks would need to include a spread for "regulatory risk."

The Committee should thus set timelines indicative of completion dates of all new standards, with clarity on the target implementation start dates and related transitions.

Section III – Concerns Related to Capital floors

I – The industry is concerned about the potential loss of risk sensitivity

36 In evaluating the SA proposals for the three main risk categories, the Associations are concerned that capital will ultimately be based on measures that do not reflect an individual bank's real portfolios and true risks.

37 The absence of the "risk sensitivity" in the present consultation is striking. We are concerned that risk sensitivity is losing importance, and caution against dissociating the capital and true risk profile of individual institutions. The pursuit of consistency and comparability is not necessarily served by approaches that assume that the risk profiles of different banks are the same when risk sensitive models demonstrate that they are not the same. Even small facts, such as a mortgage client not having its salary account with the mortgage lender can bear an important impact on Probability of Default (PD) and Loss-Given Default (LGD) model outcomes.

38 We continue to refer to the IRTF's[10] discussion of idiosyncratic and systemic risks, and perverse incentives related to limiting risk sensitivity in capital and to drawing conclusions based on simple comparisons to SA capital without due consideration of the limitations of the SA approach.

39 The Associations are (or were) engaged in efforts to respond to proposals that will alter the current SAs for credit, market and operational risk respectively; concerns on the lack of risk sensitivity include:

- Credit Risk's elimination of external credit ratings will make the SA framework less risk sensitive for exposures to externally rated counterparties; in addition, capital requirements will disproportionately increase for good quality portfolios and short term exposures. The proposal presents little differentiation between investment grade classes.
- Operational Risk's absence of differentiation by business line and the concurrent focus on "size" de facto leads to a similar lack of risk sensitivity.
- Market Risk's correlation parameters are subject to calibration, basis risk calculation is being tested as part of the ongoing QIS on FRTB; all of which can potentially adversely affect risk sensitivity. Even absent calibration changes, FRTB's standardized approach is structurally distortive as it does not recognize cross-asset diversification, despite this being a core component of risk management. Although the Sensitivity-Based Standard Approach (SBA) is an improvement over to the current standardized approach, no standardized approach will ever be able to adequately approximate the thousands of risk factors that firms typically take into account when measuring such risk. Moreover, as they stand, the treatment of the proposed risk sensitivities and the interactions between these may not be sufficiently taken into account. The calibration of the sensitivities and their interactions is pivotal to maintaining a sufficient level of risk sensitivity. If this is not to be the case, one of the FRTB's objectives, to have a credible fallback to internal models, may not be met.

[10] Notably: IIF, *IRTF Risk Sensitivity – The Important Role of Internal Models* (October 2014); and IIF, *IRTF Final Report*, Chapters on Benchmarking & Disclosure, and Appendix A.

40 Risk sensitivity is important not only for the management of risks in the banking sector, but also for supporting economic growth opportunities. If banks are able to assess and price credit correctly, savings for investments will be intermediated through banks in the most efficient way, where projects with low risk and decent returns will be able to be financed as cheaply as possible, while banks will refrain from funding projects where the risk is not commensurate with the expected return. Likewise for market risk, if banks are able to assess and price capital market transactions correctly, capital can be efficiently mobilized and diverted to productive means, helping to promote capital market activity.

41 It follows that risk sensitive approaches better capture differences in jurisdictions due to tax and legal regimes, product features, proven risk management track record and market conditions; serious concern remains for discrepancies in capital numbers under internal model approaches versus the new SAs ending up increasing, rather than being narrowed, due to such differences.

42 The Associations thus emphasize the importance of bridging fundamental risk-based differences between standardized and internal model approaches to the extent that this is possible within the constraints of the stated objective of simplicity. Paradoxically, the omission of local market factors and credit risk mitigation in the SAs could make a capital framework using SA floors less, rather than more, comparable.

II – Capital floors could camouflage risks and give investors a false sense of security

43 One of the driving forces behind Basel II was the realization that bank portfolios are not truly homogeneous, therefore the embedded risks vary between banks and portfolios, even if the latter appear at face value to be identical. In practice, banks and their supervisors are more sensitive to the specific risks in banks' portfolios, as well as to the huge variety in risk factors and their predictive power even within the same asset class. There is no such thing as "the average portfolio" or asset class, and even within a particular geography small differences in client segments or relationships can generate large differences in the risks that individual banks are exposed to.

44 If all of the regulatory requirements are based on floored capital, this will not communicate to investors the individual bank's distance to regulatory requirements, neither will the ratio be truly comparable across banks. It can be questioned whether such an approach will restore confidence in capital adequacy ratios. The true risk profile not being directly visible by assessing a bank's floored RWA means investors will turn again to internal model outcomes but those need to be harmonized to accommodate peer comparison. Hence, with an approach using capital floors the need for measures to harmonize risk weight calculation is reinforced, rather than reduced. This situation would even be exacerbated if existing capital floors put in place by local regulators remain in place and complement new Basel floors.

45 We further observe that the introduction of floors cannot resolve the issue of undue variance due to divergent supervisory practices. A floor calculation based on the SA is dependent on the interpretation and availability of granular measures needed for the SA computation, which might vary by regions and supervisory practices. This could, once again, lead to undue variance. Similar to internal model approaches, variance in risk weights should

reflect differences in risk profiles, not in arbitrary data or legal issues unrelated to risk. In this respect, we refer to the Associations' responses to Consultations on the SA for Credit Risk, Market Risk and Operational Risk.[11]

46 The proposal's requirements necessitate data collection and technology systems, and it will not capture risk in a consistent way across jurisdictions due to structural differences of banking markets, differences in accounting standards, etc. It is likely that the same complexity would lead to interpretation and implementation issues, hence dispersed results. Cost benefit analyses of capital floors should preferably take this on board. Referring again to **Appendix I**, (a combination of) alternative solutions may be equally effective while proving more manageable for regulators and banks alike.

III – Revised capital floors do not meet the criteria of "simplicity"

47 Simple measures by their very nature ought to require only the slightest effort by banks and their external stakeholders (i.e. supervisors, investors, rating agencies) to comprehend a bank's capital ratios, RWAs and underlying computations. The Associations fear that this may prove elusive. While assessing the intricacies of floor computation in the context of Question 1 and 2, banks struggled to build consensus across the range of emerging issues and the sheer complexity of the calculation. The more granular the calculations, the more complexity and questions arose. We trust the Committee will issue unequivocally clear instructions, but appreciate this may require iterations of questions and answers between the Committee and the industry.

48 More importantly, the inevitable complexity is bound to lead to confusion on the side of investors and may render future Pillar 2 SREP processes considerably more challenging.

49 Furthermore, considerations of how to balance simplicity and complexity should be centered on how to capture risk in a cost effective and well-understood way. In our view, complexity itself is not inherently undesirable – unnecessary complexity is. For instance, in the context of the FRTB and given that the SA for market risk is expected to operate as a fall back scenario that would allow regulators to switch off internal model calculations and prescribe SA methodology in the event the internal model does not adequately perform, it calls into question whether a market risk standardized approach floor is needed at all. We recommend that the regulatory goal of simplicity does not overtake the other goals.

IV – Capital floors may remove incentives for continuing improvement of risk measurement and management

50 As affirmed by many supervisors, auditors and some academics, the past decade has seen major improvements in risk measurement and this has supported the strengthening of the risk management function in banks.

[11] Joint associations' letters on the Fundamental Review of the Trading Book submitted on February 20, 2015; Joint Associations' response to the proposed revisions to the simpler approaches for operational risk submitted on December 31, 2014; and Joint associations' letter on the credit risk Standardized Approach submitted on March 2015.

51 The Associations' view is that incentives to maintain and improve internal models have and will continue to lead to better risk management and government processes. We are convinced that this will ultimately increase the resilience of the banking system. However, the capacity of risk models to contribute to financial stability can only be realized if the requisite incentives are procured. Risk modeling supports improved risk awareness and management and better pricing of risk.

While a bank has its own governance and review processes to ensure effective management of model risk, making use of internal models for regulatory capital purposes imposes significant additional costs not incurred when the same models are used solely for internal purposes.

52 For banks, it is only sensible to carry these additional costs if the regulatory community allows the outputs of the internal models to be the leading factor in setting appropriate capital requirements. Outcomes in which capital requirements are ultimately bound by more simplistic approaches with limited risk sensitivity call into question the investment to maintain and further evolve internal models in support of prudent risk management practice.

53 Internal model approaches reward proven good risk management (e.g., prudent client intake, handling of problem loans, recovery rates, etc.) and, conversely, penalize poor risk management, while standardized approaches do not. The proposed SA for operational risk capital requirements disregards the quality of operational risk management, the sensitivity of differing funding models, and the frequency of small incidents. Accordingly, the Associations promoted a framework that provides a clear link between the quality of operational risk management and the capital requirement, preserving the right incentives.

54 Assuming that a standardized floor would be calibrated such that *on average* capital levels remain the same; this would mean that the floor would restrict individual banks. This restriction will likely affect more the banks with better-than-average portfolio quality and/or risk management.

55 Similarly, the current proposal is premised on the use of risk sensitive internal models only if they lead to results above a floor. This implies that banks are stimulated to improve their risk management only until they reach that floor. Once operating on the floor or below, any incentive to further improve would be distorted and at that stage a bank could rightly question the added value of supervisory validated internal models.

56 To preserve a system that encourages banks to improve risk measurement, we advocate that the Committee incorporates a positive incentive mechanism to reward efforts to improve model quality and associated data inputs, and gives credit to related conservatisms. This could for instance be in the form of gradually released multipliers, preferably at the level of the capital numerator, thus minimizing possibilities for arbitrage and harmonizing approaches with minimal loss of risk sensitivity and model integrity.

V – Balancing external stakeholders' interests will prove more challenging

57 David Rule of the Bank of England (BoE) and others acknowledge: "whether we like it or not, banks will evaluate their activities based on return on regulatory capital requirements. So if those requirements diverge from banks' own assessments of risk, regulation will change market behavior. Sometimes that may be intended and desirable. But often it will not be."[12]

58 As described in the IRTF's "Risk Sensitivity – The Important Role of Internal Models,"[13] banks indeed have to balance the interests and requirements of different groups of stakeholders: supervisors, regulators, shareholders, bondholders and rating agencies. The institution of capital floors will directly affect how banks try to optimize their risk-adjusted returns on units of capital deployed.

59 Bank management has a fiduciary duty and obligation to shareholders to optimize returns on capital. Accordingly, banks will manage the risk of their portfolios and price loans on the basis of the then applicable binding constraint, even if this is not fully consistent with their own internal risk views or in the best interest of their shareholders. Mispricing or exits from sound businesses that serve the real economy can then not be ruled out. Once more clarity is provided on the way forward for internal model approaches and SAs, the industry can provide the Committee with real life examples of portfolios for which the business case would become unviable or barely profitable limiting further growth.

60 A capital penalty imposed by Basel for banks that do not maintain their models to the highest standard[14] would therefore not be effective. It is unrealistic to suppose that banks can ignore the levers and measures that supervisors use for regulatory capital in their decision-making processes. Capital penalties only increase the hurdle rate for loans even further. This effectively leads to capital rationing.

61 Also, ongoing increases in capital requirements may lead to a vicious circle of increasing capital issuance, which then result in dilution and lower investor returns making future financing rounds costlier. Ultimately shareholders are not necessarily looking for low risk and fully predictable and stable cash flows – for that they can buy utility stocks – but appropriate return per unit of risk borne.

62 An unsustainable situation in which the cost of capital is structurally higher than the return on capital should be avoided at all cost. It could push banks to decide on selective deleveraging, increased pricing or other undesirable effects. Low risk products and clients are likely affected most. While we recognize that the Committee's primary objective is to ensure a bank's adequate level of capitalization, this will ultimately be influenced by its capacity to remain profitable in the long run.

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[12] David Rule, Bank of England, *What is left to do on the post-crisis bank capital framework*, Institute of International Bankers (IIB) Seminar (March 2, 2015).
[13] IIF, *IRTF Risk Sensitivity – The Important Role of Internal Models* (October 2014).
[14] Stefan Ingves, *Restoring confidence in banks, Keynote address to the 15th Annual Convention of the Global Association of Risk Professionals* (New York, 4 March 2014).

63 In short, whilst organizations will have their own internal risk assessment systems which would be part of their consideration when deciding who to lend to and what pricing grid would be used, the reality is that the amount of regulatory capital that is deployed will be one of the key drivers of that decision. Already at present banks are struggling to get their returns on equity above the cost of this equity.

VI – SA capital is not necessarily accurate

64 The Associations contest the assumption that whatever the standardized measure is, if it results in higher capital, this higher capital must be the "truth." This cannot be established without looking at the real portfolio or asset class and its associated risks. Bank, jurisdiction, portfolio segment, the quality of a firm's risk management, or market-specific mitigating factors could simply positively affect the risk profile in one bank of what at first glance seems a homogeneous asset class or portfolio across the industry.

65 Research comparing SA risk weights and internal model risk weights[15] showed that average risk weights of banks using internal model approaches are both lower and higher compared to SA risk weights; it all depends on the quality of the individual portfolio, the level of concentration risk and the effectiveness of the risk management function within the firm.

66 Further, while a SA may be suitable for plain vanilla products and relatively simple portfolios, it will be considerably more problematic to represent and rank order complex heterogeneous portfolios. Only sophisticated models have the capacity to distinguish between and within -and reflect- real portfolios. For instance, SAs have limitations in recognizing portfolio diversification, and do not capture private information that banks have on their customers. Robust internal models mix statistical data, private information and expert judgment, and as such have the capacity to reinforce and complement sound risk, capital and portfolio management.

67 If SAs are used to floor capital of banks using internal model approaches, a more fundamental debate seems warranted on the relationship between standardized risk weights and internal model equivalents. Before reaching final decisions, we would therefore recommend to address fundamental questions such as:

- How to balance accuracy and prudence given that floors will be based on SAs that in turn are calibrated against a mean;
- What kind of portfolio diversification, correlations and weightings of PD and LGD type factors are assumed in the new standardized risk weights for credit risk;
- How the low risk of high quality portfolios will be reflected in the new SAs to ensure that incentives for low risk portfolios are preserved; in the same vein, how granular risk differentiation and rank ordering will be retained in a framework dominated by SAs; and
- In view of the review of AMA approaches, how granular historical operational loss data will in the future be captured to produce the required level of differentiation and rank ordering to avoid under- or overcapitalization due to a calibration against a "mean" and to reflect complex business models. The Revised Standardized Approach (RSA)

[15] For example, PRA *Pillar 2 Consultation*, p.74.

calibration does not include large banks that typically use the AMA approach and therefore may not be appropriate as reference point. In line with the key objective of preventing underestimation of risk, it is equally important to understand how dispersion in the outcome of operational risk calculations based on internal models will be captured to revalidate the correlation between measurement units.

VII – Capital floors may alter the traditional roles and responsibilities of regulators, supervisors and banks

68 The original objective of the Basel Accord was to ensure that banks were at least minimally capitalized to support financial stability. As national divergences in business models are significant, both internal model approaches and SAs were to be supplemented by national supervisors' responsibility to make sure local banks are well capitalized. SAs were in fact never constructed as substitutes for risk sensitive approaches since incentives were built in to move over time to the more risk sensitive internal model approaches.

69 The Consultation Paper implies the restated objectives of the SAs are to:

- Ensure financial stability through adequate capitalization
- Be risk sensitive through a (one-size fits all) more granular standardized approach
- Prioritize comparability of RWA

70 To that end, the responsibility and accountability seems to shift from banks and their local supervisors to the Basel Committee. The crucial and fundamental role of national supervisors to apply judgment and adjust for local intricacies may end up being eroded. Risk managers and local supervisors should ideally retain their full ability and responsibility to develop and act upon forward looking views and changes in market conditions with risk measures changing continuously along new predictive abilities. Too rigid regulatory views might limit this ability.

If regulators become more active in shaping outcomes, this could de facto imply additional accountability for outcomes.

VIII – Capital floors could generate cliff effects

71 Depending on the calibration of capital floors, large divergences between SA and internal model approaches have the potential to generate undesirable cliff effects, and this incentivizes pro-cyclical behavior.

72 For instance, the credit risk SA uses a EUR-based revenue metric for corporate exposures. Changes in, and volatility of, currency rates as can be expected in certain developing markets and in other jurisdictions, may imply that from one month to another capital floors can suddenly hit a bank forcing the bank to speedily shift portfolio strategy. This forces such banks to hold at all times capital buffers in excess of the regulatory imposed buffers. Further pricing distortions for high quality assets could then occur.

IX – SA and Internal Model approaches are not fully comparable

73 If new capital floors are applied, it is important that the comparison is done on a like-for-like basis. Currently, the Credit Risk SA and IRB approaches for instance do not have similar starting points. The Consultation paper refers to a possible correction of provisions and of the expected loss shortfall calculation but does not include a reference to the difference in exposure value: the SA exposure is measured net of specific provisions whereas IRB is gross of provisions. IRB banks additionally use internal segmentation, which may be unaligned with SA asset classes and could prove problematic especially if the decision is to apply granular floors. Also, indicators used for the Operational Risk AMA and SA are not comparable either. Operational Risk AMA models have been developed based on internal segmentation and the quality of operational risk management at banks whilst the proposed new Operational Risk SA segments risk according to the amount of income and expense of an individual bank.

74 Also, differences in financial accounting practices across different jurisdictions will result in variance in measures used in SAs, which may in turn generate undue variance in capital floors.

75 We therefore caution against capital floors that could undermine the objectives of transparency and confuse recipients of disclosure information.

X – The interplay between capital floors, regulatory stress testing and Pillar 2 is unclear

76 The Associations wonder how Pillar 2, regulatory stress testing and capital floors will complement one another, and similarly question whether double counting of buffers and conservative adjustments derived from these different processes can be avoided.

77 Stress testing is precisely intended to test capital against exposures under stress and should therefore highlight any inadequacies with the calculation of RWAs and address the issue of unexpectedly large losses in low RWA portfolio. Furthermore, capital buffers help to enhance the capital requirements and in some cases serve to introduce floors, e.g. in certain jurisdictions, the use of sectorial capital requirements can be seen as analogous to exposure class floors.

78 Model risk (mentioned in paragraph 11 of the CP as a driver for capital floors) is also an intrinsic part of Pillar 2: for instance, the new EBA guidelines refer to model risk in various instances.[16]

79 Therefore, tail risk and high frequency losses may already be captured through stress testing and scenario analysis as part of either Pillar 1 or Pillar 2 assessments between banks and regulators taking account of the risk management environment, and it is unclear how these processes will be enacted in a context of tight capital floors.

80 For instance, we are concerned about Pillar 2 (both the Internal Capital Adequacy Assessment Process (ICAAP) and Supervisory Review and Evaluation Process (SREP)) in the context of the FRTB. The industry is supportive of the aim of the FRTB to increase the risk

[16] *Final Guidelines for common procedures and methodologies for the supervisory review and evaluation process* (SREP) (December 2014), paragraphs 235 and 262-267

sensitivity of the standardized approach and to make it a real alternative to internal models that underperform. However, we are concerned that the risk sensitivity of the trading book framework may be hampered by additional floors that are considered in the FRTB framework and elsewhere (e.g. model-independent risk assessment tool and standardized floors within the framework and TLAC and leverage ratio as separate floors). These multiple floors at different levels of consolidation are likely to have a cumulative effect on the overall level of capital and fundamentally reduce risk sensitivity of the regulatory capital. Additionally, the consequent misalignment of regulatory capital and economic drivers of Profit and Loss (P&L) is likely to lead to suboptimal risk management practices. Such lack of use test (i.e. the regulatory capital does not rely on the same risks and principles as the firms' economic capital models) may create perverse incentives for business decisions that change offerings and pricing of financial products. Furthermore, firms may need to run separate models for economic and regulatory capital, increasing IT and risk management costs for trading activities. These use test breaches will complicate capital governance for banks and their supervisors.

81 If no due consideration is given to regulatory governance and to the interplay between regulation and supervision, overstatements of risk or conflicting messages and opposite effects might result.

82 If and when floors are applied, we recommend giving full consideration to (gross) overstatements of capital due to the application of floors. Such observations should become part of the overall capital assessment under Pillar 2.

Section IV – Other relevant observations

I – Some RWA variance is desirable; undue RWA variance can be eliminated

83 The Associations note that variation in model derived RWAs is a natural by-product of a framework that gives credit to differences in portfolio segments and strategies, business models, and a bank's proven risk management and recovery practices. Seemingly similar portfolios can represent different risk profiles because of different portfolio concentrations, product focus, or the strength of the client-bank relationship. Some banks are simply more successful in managing problem clients than others, which is reflected in their LGD parameters. In addition, credit risk management (and models) involves expert judgment and is vital to a sound system in which risk and business managers are required to critically assess individual risks rather than blindly implementing a common view. All of these differences are desirable.

84 We observe that model risk is not confined to banks' internal models. Different views on riskiness of counterparties contribute to financial stability by avoiding herd mentality and the development of a single standardized view that may ultimately prove wrong.

85 Regulatory benchmarking exercises[17] in actual fact have not found evidence of positive or negative bias in internal models. Even if lower capital requirements under internal models were the result of unjustified variance in bank modeling approaches or supervisory interpretations, this is currently being remedied by efforts of various regional and global supervisory, regulatory and industry working groups (including the IRTF) who are all working towards unambiguous and harmonized modeling approaches. The industry is therefore convinced that these efforts can yield the desired results, and that supervisors in their SREP could resolve any remaining issue via regulatory benchmarking and stress testing exercises. Negative side effects of blunt capital measures such as the perverse incentive to go down the credit curve, change sound risk management and underwriting practices, and/or re-price, could then be avoided.

86 Reducing unwarranted variance due to modeling approaches or definitional differences, should anyhow remain a priority in view of Pillar 3 disclosure. Thereafter, benchmarking exercises will demonstrate how RWA variance has evolved and thus have the capacity to restore market confidence in internal models.

87 Ultimately variation in model-derived RWAs should not and cannot be constrained by way of capital floors. This variation should better be reduced by developing targeted regulatory guidance and by implementing supervisory standards, principles and generalized criteria that must be applied consistently across the globe. As could be inferred from the IRTF[18] sensitivity analysis of a number of variance drivers, undue variance is manageable and any future outliers can be monitored by way of recurrent benchmarking exercises.

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[17] For example, European Banking Authority Report, *Summary report on comparability and pro-cyclicality of the IRB Approach* (17 December 2013).
[18] IIF, IRTF Final Report, Chapter 1.5.

Assessing the current proposals for new SAs, capital floors will very likely create a new form of variance, which will be much less transparent. We strongly believe that the objective of simplicity is better served by harmonized modeling approaches that eliminate undue variance while preserving risk sensitivity, rather than by putting in place a myriad of capital floors that in the end could obscure true risks.

II – The cost of supervisory internal model validation is justified

88 Some regulators have raised the concern of high recurring costs of reviewing, validating and approving internal models and of monitoring ongoing model performance; they believe capital floors reduce these costs. The Associations acknowledge that the cost of supervisory model validation is high, but believe that this is justified:

- Risk modeling provides the foundation required for supervisors to exercise their SREP obligations. A Pillar 2 process will prove infinitely more challenging and costly without a Pillar 1 based on internal models.
- Risk models are not stand-alone tools but embedded in internal credit processes and reflective of portfolio risks; supervisory model reviews therefore may entail a certain cost, but at the same time procure supervisors with information and insights on bank's portfolios and risks which are invaluable and not easily obtained otherwise. The existing model governance as such has created a well-established forum for a detailed review of portfolio risks.
- Under the new impairment regime, banks will leverage and further develop their capital models for forward-looking provisioning. Given the link between accounting and prudential standards, and in particular regarding the prudential Expected Loss (EL) and EL shortfall calculation, supervisors and regulators will have a necessary role.

III – Choice of SA (paragraphs 25-26)

89 The industry notes that the Basel Committee has decided to apply a capital floor based on the SA that exists in the jurisdiction in which the bank operates. We believe that consistency in the measurement of the SA, and therefore the intended capital floor, is preferable. This is designed to mitigate the scope of possible discrepancies among banks globally. Without the use of harmonized definitions and concepts, we are concerned that the Basel Committee's approach may not meet the goals of greater transparency and comparability.

90 The new SA is subject to interpretation risk. This largely reflects substitution of uniform external ratings with dual risk drivers that leave room for diverse interpretations, implementation practices and effects that vary according to local accounting, tax and legal regimes. Also, and echoing our comments made in the context of revisions to the SA for credit risk, the use of the Common Equity Tier 1 (CET1) ratio as a measure of bank exposure assumes that definitions and capital approaches are consistent, which is not the case.

91 Nevertheless, we concede the reality that certain jurisdictions already have in place their versions of the SA and in some cases, their version of a capital floor. Requiring these jurisdictions to alter their approaches to meet a revised Basel Committee standard would be onerous. This includes substantial compliance burdens and distinct capital floors.

92 As such, we take no position on the issue of the choice of the SA in the establishment of a capital floor, except to emphasize the importance of harmonization in the risk-based capital framework, balanced by the need to accommodate local circumstances.

Section V – Responses to Questions

93 It is premature to form an opinion on the desirability of different options over others where many uncertainties surround the internal approaches as well as the SAs. Until more details are known about how this will unfold in practice, we can only list below some points for consideration with a clear caveat that this should not be misconstrued as a final industry position. The Associations' positions can therefore only be taken as provisional and subject to change. For instance, the institution of exposure class or risk parameter floors in credit risk may change the perspective of banks on the choice between risk-category based and aggregate floors.

94 The Associations reiterate that they are not convinced that there is a real need for capital floors given many other existing or possible alternative solutions to deal with current or possible future weaknesses of the current Basel framework. Nevertheless, in case the Basel Committee opines and decides otherwise, the Associations wish to advance the following general observations related to the choice between different floor levels and between options to adjust for provisions.

I – Capital Floors computation: Scope and Form

95 The Joint Associations' interpretation of the Consultation Paper is that the Basel Committee intends to have capital floor(s) based on new SAs in place. It is however unclear *how* floor calculations will be done in concrete, and if and how different risk categories will be involved:

Scope

96 Based on the QIS templates distributed since the publication of the Consultation Paper, it would appear that Counterparty Credit Risk, Credit Valuation Adjustment (CVA), central counterparties (CCPs) and Securitization capital are considered in the recalibration of the capital framework. The Associations welcome this inclusion of all capital components in the overall calibration discussion. It is however not entirely clear whether these risk categories will even be included in the capital floor computation. In this respect, we note in particular that there has not been any prior discussion on the need for securitization capital to be floored by a SA: in fact, the use of internal model information in the securitization capital framework is limited to the Securitization Internal Ratings-Based Approach (SEC-IRBA) approach based on Kirb of the underlying pool and the revised framework is designed and calibrated to mitigate model risk.

97 Flooring securitization capital and requiring banks to implement both a SA and one of the approaches higher in the securitization hierarchy could defy the purpose of any effort to introduce a preferential treatment for simple, transparent and comparable securitization transactions. This treatment is being considered for the explicit desire to promote (good quality) securitization, which is seen as a key-contributing factor to economic growth.

98 In this context, and if it is intended that securitization capital will be subject to the SA capital floor, we also wish to confirm our understanding of the relationship between the

securitization framework and the SA floor. To apply the SEC-IRBA to a securitization exposure, a bank has to calculate the IRB capital requirement (Kirb) for the underlying pool of exposures.

99 Because the SA floor will apply to aggregate capital within a risk category or across risk categories, and not to the capital requirements for an individual exposure or pool of exposures, the bank's calculation of Kirb and SEC-IRBA capital for a securitization exposure would not take account of the SA capital floor. However, the bank would also have to calculate the capital requirement for that securitization exposure using the Securitization External Ratings-Based Approach (SEC-ERBA) (where permitted and conditions are met) or the SEC-SA, include that capital requirement amount in the overall SA capital floor, and apply that SA floor on aggregate basis by comparison with the bank's aggregate capital based on IRB and, as applicable, other advanced approaches.

100 Furthermore we note that in the trading book the securitization framework is still under review as part of the FRTB and subject to testing in a separate QIS that is expected to commence imminently, therefore any conclusion on the risk sensitivity properties of the proposed framework at this stage would be premature.

101 The application of the SA floor to securitization capital would also raise a question about banks' ability to apply the securitization capital requirements cap when acting as investors. The framework allows a bank to apply a maximum capital requirement for all its exposures to a given securitization transaction equal to the capital requirement that would have applied if the bank held all the underlying exposures directly. Under the revised framework, a bank using the SEC-IRBA can apply this cap when acting as originator, sponsor or investor, while a bank using the SEC-ERBA or SEC-SA can apply the cap only when acting as originator or sponsor and not when acting as investor. The Committee's explanation for this difference in treatment was that banks applying SA tend to have less detailed information about the underlying assets. If a bank with IRB authorization acting as investor calculates its aggregate capital requirement for a securitization transaction using SEC-IRBA, it can apply the capital requirements cap, but when it calculates its SA capital requirement for the same transaction to put into the SA floor, the revised framework seems to say, it will not be able to apply the cap. Our view is that this would be an unintended and inappropriate result: the IRB investor bank should be able to apply the cap when using SA for purposes of the SA floor.

102 These last questions are illustrative of the sheer complexity of connecting all the dots in the calibration of the capital framework and of providing detailed computational instructions related to new capital floors.

Form

103 The Consultation Paper does not provide sufficient information on the mechanics of the floor computation, and assumptions appear to be made in paragraphs 20-24 that are unaligned with the question described and raised in paragraphs 17-19. It is further unclear how the buffer requirements will be treated under a capital floor, i.e. whether buffers will be based on a floored or un-floored RWA, and how Pillar 2 fits into the equation.

104 We further note that Question 1 seems to be two-dimensional: it is not only about the level of aggregation (across all risk categories vs. by risk-category), but also about the level of application (RWA vs. capital). The Associations would like the Committee to clarify why this second dimension is included as RWA floors and capital floors are expected to achieve different objectives.

II – Alternatives to Capital Floors Based On SAs

105 There is no explicit reference in the Consultative Paper to alternative forms of floors being considered. We believe that some alternative routes could be explored further that might strike a better balance between the BCBS objectives of risk sensitivity, comparability and simplicity, The Associations stand ready to provide some suggestions once more detail is provided by the Committee on its intentions and the full suite of proposals is in its final stage of development.

106 Without prejudice to the above, and as previously stated in this paper, we suggest that the Basel Committee explores the possibility of keeping the existing capital floors (e.g. Pillar 1 floor or other existing floors) in place **for a pre-specified period of time** (i.e. allowing for some time to evaluate if benchmarking exercises show that no more undue RWA variance exists after harmonization efforts, and if the so-called "un-modelable" risks issue has been resolved to the satisfaction of the regulators).

III – Position of the Joint Associations

107 Were the BCBS to decide that capital floors are needed in addition to other tools and processes in place to remedy possible shortcomings of internal model approaches, the Associations recommend in conformity with the statement by Chairman Ingves in the context of the discussion on the leverage ratio that the floors will be *"floors that constrain some of the banks some of the time, but not most banks most of the time,"* i.e. that the floor calibration should result in SAs not overriding or wiping out internal model approaches unless there is a sound prudential rationale and all other possible remedial actions are already exhausted.

108 Also, the calculation of a capital floor should be translated as an amount of additional own fund requirements, rather than a presentation of a different set of ratios or direct replacement of RWAs.

109 Analysis by regulatory authorities and by the IRTF showed that conservative adjustments and discretionary floors currently imposed by supervisors on banks using internal model approaches have taken many different forms and are made at different levels in the computation (i.e. in the capital ratio denominator, either in Pillar 1 or in Pillar 2, or in the capital ratio numerator). If the current adjustments at local level are not eliminated when Basel floors are put in place, these differences potentially affect the comparison between SA and internal model approaches and the resulting RWA and capital ratio. We therefore advocate that the floor design be unequivocally clear and unambiguous to ensure its consistent interpretation and implementation across the globe. We further promote the elimination of local model-based or

portfolio-based floors and full reconsideration of other local adjustments that aim to remedy the same weaknesses.

110 Furthermore, we would not wish to see front running and gold plating of the Basel proposals by national authorities; this could defy the purposes of fair competition and transparency.

IV – Answer to Question 1: Level of aggregation of risk-categories

111 Although the Basel Committee has indicated that the impact of a risk-category based floor and an aggregate RWA floor will be similar on average, the Associations have agreed that there is not enough information regarding the calibration or the nature of the two floor options to reach an informed consensus position. The qualification "on average" ignores the fundamental concern that banks will be impacted differently based on their average risk weight density and relative exposure to credit, operational market and other Pillar 1 risks imposed by national supervisors. We urge the Committee to provide more information that would allow banks to test the different outcomes, as these will almost certainly differ depending on business models. A second consultation round will hopefully serve this purpose and benefit banks and regulators alike.

112 Currently, the Consultation Paper presents three options for the level of aggregation of the risk categories – through a risk-category capital floor (for credit, market and operational risk), a floor based on total RWAs (aggregate RWA-based floor), or undefined floors on exposure class level. The above options are not clearly fleshed out, and present no clear link to Question 2 of the paper. Therefore, the Associations find it challenging to opine on the preferred level of aggregation, especially with the possibility of asset class and parameter floors or other solutions and the lack of detail on the final SAs.

113 Whilst all banks thus agree that it is premature to formulate a final position, the majority of our member banks have expressed an indicative preference for an aggregate floor over more granular floors.

114 Further, in case the Committee decides to put targeted solutions in place at a granular asset class or other level, we do not believe that an additional floor is adding any further benefit to a system that already has a leverage ratio floor in place. Moreover, a multidimensional floor design would in our view not serve the objective of simplicity. We are of the opinion that multiple floors or a layering of floors is not only redundant, but also could easily result in confusion with no stakeholder knowing the real risk-capital accuracy.

115 In case the Committee's choice is to put in place a single aggregate floor, this should not preclude a separate calibration of the different risk categories. Calibration can in the first instance be done for each separate risk category, after which they feed into an aggregate calibration; the observed flaws found in, respectively, market risk, credit risk and operational risk models are different, and this should be fully recognized in calibration discussions.

Considerations pertaining to an aggregate floor

116 The relative advantage of an aggregate floor over more granular floors is twofold: (1) it supports the BCBS stated objective of simplicity and (2) it provides flexibility to the banks while still achieving the prudential goal of overall minimum capital adequacy. An aggregate floor would also assist ease of comparison across banks.

117 Banks could approach each risk category with fewer boundaries and could hope to act largely in accordance with their internal risk view. For instance, they could freely decide to hedge their banking book exposures by buying protection, which would be booked in the trading book. Banks presumably will be able to offset, at least to some extent, the above-described effects on pricing, capital allocation and portfolio choices that capital floors would invariably generate.

118 As such, it would provoke the least intervention in bank's business models and in risk based pricing and remuneration. Most likely, no business model would be penalized unfairly compared to another.

119 It would also be least disruptive from an operational point of view and least confusing for external stakeholders; it would leave room for vital internal (capital allocation and risk management) and external (analyst due diligence) processes.

Considerations pertaining to a risk-category based floor

120 An aggregate floor may not be necessarily neutral across banks with different portfolios and different weightings of credit risk, operational risk and market risk RWA.

121 Risk-category based floors therefore may provide a more precise measure to be used in internal risk management and in bank supervision as they accommodate a more targeted intervention.

122 The growth of exposures related to one risk category will not be unduly hampered due to the overall floor put in place covering and calibrated against all risk categories taken together. Also, the effective (post floor) risk weight in one risk category is unaffected by risk weight changes in other risk categories.

123 However, evolving risks and new insights may not be captured easily or timely, and sound business practices could be affected negatively.

Considerations pertaining to granular (exposure class/risk parameter) floors

124 The Associations are cognizant of the fact that the BCBS is considering to target specific issues in particular portfolios and their associated models. Such an approach would directly address the core issues and offer a granular reference point for internal models. The Associations are also aware that these targeted solutions could take the form of granular floors.

125 While this indeed poses the dual advantage of replacing the current situation of locally applied solutions (floors or other adjustments) by national regulators and supervisors, which contribute to an un-level playing field, and of keeping the integrity of portfolio models that are deemed adequate intact, there are some repercussions that need careful consideration:

- This solution reduces the flexibility of national supervisors to adjust for local contexts.
- Such granular floors therefore require very accurate SA risk weights, which will prove rather challenging given huge differences between real portfolios and their legal, social and macro-economic contexts.
- The more granular floors are, the more challenging it will prove to resolve mapping issues. This could lead to complexity and even arbitrage.
- Rigid floors may target problems, but at the same time stifle innovation. In the same vein, evolving risks and new insights might not be captured timely.
- Exposure class floors further embed a risk of potentially high cliff effects.

V – Question 2: Treatment of Provisions

126 The Associations appreciate that the Basel Committee recognizes the need to address the lack of comparability between internal model approaches and SAs with respect to provisioning. We share the belief that it is important to provide a fair and equitable adjustment that will create a level playing field across jurisdictions.

127 The Consultative Document provides two suggested approaches to adjust for differences in provisioning, Option 1 taking the form of an adjustment to the numerator of the capital ratio, and Option 2 through adjusted RWAs. The Associations observe that the text and examples provided in the consultative document are unclear and subject to different interpretations within the industry.

128 The choice of one option over the other is intrinsically linked to the mechanics of the calculations; therefore without an explicit description of the mechanics of the calculation, banks do not have sufficient information to assess the consequences of either option and thus to reach a final position. Furthermore, the text does not procure clear proof that either Option 1 or 2 is conceptually and mathematically sound.

129 The ambiguity in the proposed application of the capital floors poses significant issues in the calculation and application of the floor and the treatment of provisions. This could potentially create complexity and confusing disclosure requirements as well as unintended effects and conflicts with aspects of the wider capital framework. Also, the calculation of a capital floor should be translated as an amount of additional own fund requirements, rather than a presentation of a different set of ratios or direct replacement of RWAs that would have an automatic and unjustified repercussion on other elements of the wider capital framework. The final calibration of both the SAs and internal model approaches, and of capital floors, should equally take a detailed account of systemic risk buffers, capital conservation buffers, Global Systemically Important Bank (G-SIB) buffers, and countercyclical buffers. The interaction between the leverage ratio, TLAC, and the capital floors should equally be part of this comprehensive

analysis when assessing the floor design and the choice between risk-category based floors and an aggregate RWA floor.

130 Further, at this stage the implications of the changes in the impairment regime for regulatory capital standards are unknown. The Basel Committee has indicated it will revisit the EL shortfall/excess computation in view of those changes. This may influence the view on the best approach to the application of the treatment of provisions in the application of the floor.

131 Several key questions have arisen from both Option 1 and Option 2; these key questions are presented in Box 5 below.

Box 5: Key Questions	
General Questions	
1	How would the treatment of provisions and the proposed application of the floor interact with the capital buffers, leverage ratio, large exposures, TLAC, and other related standards? Clarification is essential on this point (and for any options being considered). It is unclear how any of the options presented would enable a coherent application of a capital floor (the examples need to detail the calculation of impact vis-a-vis the overall capital framework.
Option 1	
1	In Box 2 of Basel's Consultation Paper, the following sentence creates confusion and needs further clarification "The bank would add these general provisions when calculating its capital ratio for the purpose of calculating its capital ratios under the internally modeled and standardized approaches (i.e. its total capital resources would be 100 + 33 – 3 + 8 = 138)." Should the IRB ratio be kept unchanged for comparison with the standardized ratio (the latter being the calculated "standardized approach measure of capital" divided by the standardized RWA x floor factor)? Or should both ratios be adjusted? In any case it is essential to account for the different calibration of RWAs under standardized and IRB (EL+ UL vs. UL only).
2	In case the ratios under the SA are higher than IRB ratios, is the proposal in the consultation that the final Total Capital and CET1 measures the standardized equivalents used for the floor calculation?
Option 2	
1	How would the RWA adjustment work if EL were higher than Provisions (i.e. CET1 capital deduction RWA equivalent has to be added to IRB RWA)?
2	If the floor is hit would that mean that, in addition to RWA, capital would also need to be adjusted for regulatory reporting purposes? Would the final capital ratios (to be reported and disclosed) then have adjustments to both the numerator and the denominator? In case there is a shortfall does it means that this deduction must not be considered in the final capital amount?

132 Currently, under the SA the EL amounts are unknown as the standardized risk weights are inclusive of both EL and Unexpected Loss (UL), and firms are allowed to include general provisions in Tier 2 to cover EL.

Under the IRB approach, EL must be calculated and the Basel Committee requires a bank to capitalize the portion of EL that is not covered by provisions.

As outlined in the question in Box 5 above, if under Option 1 both capital resources for standardized and IRB ratios are to be adjusted, there appears to be a fundamental flaw in the calculation methodology of Option 1, given that the IRB function currently does not correct to include EL. In order to remedy the situation, EL could be capitalized into an RWA equivalent.

133 The Associations urge the Basel Committee to provide banks with detailed examples illustrating more precisely what the mechanics of application of the floor should be. However, in order to illustrate the different interpretations within the Industry, the Associations are presenting below their interpretations based on the text and examples provided in the consultative document. These are presented in Box 6 and Box 7 below. We have improved the simulations by adding the impact on CET1 ratio of the proposed floor options, as regulators, supervisors and market participants are increasingly looking at the CET1 to assess a bank's financial strength.

Example from Basel Capital Floors CP: Box 2		
	STD - current	**IRB – current**
CET1	100	100
Tier2 (excl. Provisions)	30	30
Eligible provisions	10	10
of which gen	8	8
EL	0	7
Capital resources	138	133
CR RWA	1150	800
Capital ratio	12.00%	16.63%
CET 1 ratio	8.7%	12.5%
Caps on provisions		
.6% CR RWA		3.36
1.25% CR RWA	10.0625	

Note: for the examples we will assume an illustrative floor factor of 80%.

Box 6: Interpretation to Option 1			
Interpretation 6A	**STD option 1**	**IRB option 1**	**Explanation**
CET1	100	100	
Tier2 (excl. Provisions)	30	30	
Eligible provisions	10	10	
of which gen	8	8	
EL	0	7	
Capital resources	**138**	**133**	
CR RWA	1150	**800**	
Capital ratio	12.00%	16.63%	The IRB capital ratio remains unchanged for comparison with the floor, adjustments to capital resources are purely made to determine regulatory capital to calculate ratios under the SA. The Associations believes this will be the logical

			approach; however it is unclear if this is in line with Box 2 of the BCBS text which implies that the adjustments to capital resources are to be applied to both IRB and SA ratio calculations. We urge the Basel Committee to clarify if this was indeed a mistake in Box 2 "The bank would add these general provisions when calculating its capital ratio for the purpose of calculating its capital ratios under the internally modeled and standardized approaches (i.e. its total capital resources would be 100 + 33 – 3 + 8 = 138)." If it was intended that both capital resources for SA-CR and IRB are adjusted to 138 then the consequence would be that Option 1 needs to be adjusted to increase RWA under IRB by capitalizing EL. Under this exercise, the unfloored IRB capital ratio is 15.55% instead of 16.63%.
CR RWA Floored @ 80%		1150*.8 = **920**	
CET1 ratio with 80% floor		100/920= **10.87%**	
Capital ratio with 80% floor		138/920 **=15.00%**	

"No General Provisions" Scenario Interpretation 6B	**STD option 1**	**IRB option 1**	**Explanation**
CET1	100	100	
Tier2 (excl. Provisions)	30	30	
Eligible provisions	10	10	
of which gen			IAS 39 provisions on performing exposures that are treated under the SA are considered in the EAD calculation. Therefore, this scenario does not show any general provisions.
EL	0	7	
Capital resources	**130**	**133**	
CR RWA	1150	800	
Capital ratio	11.3%	**16.63%**	
CR RWA Floored @ 80%	1150*.8 = **920**		
CET1 Ratio floored at 80%		100/920= **10.87%**	
Capital ratio with 80% floor		130/920 **=14.13%**	

Box 7 introduces an interpretation of the example provided under Box 2 of the Capital Floors Consultation Paper. A column has been added to explain the different interpretations.

Box 7: Interpretations to Option 2			
Interpretation 7A:	**STD option 2**	**IRB option 2**	**Explanation**
CET1	100	100	
Tier2 (excl. Provisions)	30	30	
Eligible provisions	10	10	
of which gen	8	8	
EL	0	7	
Capital resources	130	130	
CR RWA	1150 – (8*12.5) = **1050**	800 – [min (10-7 ; 3.36) * 12.5] = **762.5**	
CR RWA Floored @ 80%	1050 *.8 = **840**		
CR RWA (step 2)		800 + (840 – 762.5) = **878**	Members interpreted Box 2 as needing to add the difference between the adjusted SA RWA (multiplied by the floor factor) and the Adjusted IRB RWA to the original IRB RWA
CET1 ratio with 80% floor	12.38%	100/878 = **11.4%**	The Capital Ratio after applying the floor will then be calculated by removing excess provisions from T2 as per last paragraph of Box 2
Capital ratio with 80% floor		130/878 = **14.81%**	
"No General Provisions" Scenario Interpretation 7B	**STD option 2**	**IRB option 2**	**Explanation**
CET1	100	100	
Tier2 (excl. Provisions)	30	30	
Eligible provisions	10	10	
of which gen			IAS 39 provisions on performing exposures that are treated under the SA are considered in the EAD calculation. Therefore, this scenario does not show any general provisions.
EL	0	7	
Capital resources	130	130	
CR RWA	**1150**	800 – [min (10-7 ; 3.36) * 12.5] = **762.5**	
CR RWA Floored @ 80%	1150 *.8 = **920**		
CR RWA (step 2)		800 + (920 – 762.5) = **957.5**	Some members interpreted Box 2 as needing to add the difference between the adjusted SA RWA (multiplied by the floor factor)and Adjusted IRB RWA to the original IRB RWA
CET1 ratio with 80% floor		100/957.5 = **10.4%**	
Capital ratio with 80% floor		130/957.5 = **13.58%**	

134 Considering the importance of CET1, the Associations have deemed it appropriate to provide additional simulation examples in order to take into account scenarios where the EL is higher than the provision level, therefore implying a deduction from CET1 by banks applying IRB approaches. Box 8 below provides a shortfall example.

Box 8: Shortfall Examples			
	STD	**IRB**	**Explanation**
CET1	100	100	
Tier2 (excl. Provisions)	30	30	
Eligible provisions	10	10	
of which gen	8	8	
EL	0	15	EL has been changed to 15 in order to create a shortfall example
Capital resources	**138**	**100+30+0 – 5 = 125**	
CR RWA	1150	800	
Capital ratio	**12.00%**	**15.63%**	
CET1 Ratio before floor	8.7%	100 – 5 / 800 = 11.88%	
Based on Interpretation 6a (Option 1)			
CR RWA Floored @ 80%	1150*.8 = **920**		
CET1 ratio with 80%		100 / 920 = **10.87%**	
Capital ratio with 80% floor		138/920 **=15%**	
Based on Interpretation 7a (Option 2)			
	STD	IRB	Interpretations:
Adjusted IRWA (CR RWA Adjusted)	1150 – (8*12.5) = **1050**	800 – [min (5; 3.36) * 12.5] = **862.5**	
CET1 for floor calculation		**100 – 5 = 95**	
Adjusted SRWA (CR RWA Floored @ 80%)	1050 *.8 = **840**		
CR RWA (step 2)		862.5 is higher than 840, therefore we use 800	
CET1 ratio with 80% floor		95/800 = **11.88%**	
Capital ratio with 80% floor		(95+30)/ 800 = **15.63%**	

135 Given the uncertainties around interpretation of the options under consultation, and the issues arising from the fact that both result in adjustments to the capital ratios (on both sides) it is not possible to express a preference or support any of the options as drafted. Although Option 1 allows to distinguish between provisioning adjustments made to CET1 and Tier 2 capital, overall, a concern with Option 1 is that it seems to involve a comparison of capital resources and requirements under two different bases.

136 A major concern with Option 2 will affect all three capital ratios, making it very difficult for banks to implement the adjustment. We would also note that Option 2 requires that provisions be converted to a RWA equivalent, which raises the open question on what conversion ratio will be applied. In the past, the obvious answer would be a 1250% risk weight based on an 8% capital ratio, however presently this 8% no longer has an objective substance (if it ever had). Nowadays, many banks are required to hold substantially higher capital ratios, which make the 1250% risk weight into an arbitrary choice disconnected from the fundamentals of the business.

Option 2 further introduces an inherent inconsistency with the new SA risk weights proposed by the Basel Committee where the CET1 ratio is used. Specifically, if excess provisions were used to adjust RWA, the CET1 ratio would change accordingly creating an unexpected incentive for banks to accumulate more Tier 2 resources.

Appendix 1 – Remedying perceived weaknesses in internal model approaches

The Basel Committee wishes to mitigate risks and perceived weaknesses of internal models by putting in place capital floors. The Associations urge the Basel Committee to fully consider measures and processes already being developed or put in place post-crisis that attempt to capture the same weaknesses.

Perceived Weakness	Addressed by:
Possibility of undue optimism in models	• A well calibrated Leverage Ratio as a backstop not taking into account risk mitigation • Pillar 2 • Internal and Regulatory Stress testing • Good quality supervision and consistently applied supervisory standards • Similar for internal Model Validation
Model risk	• Leverage ratio • Capital buffers • Margins of Prudence • Pillar 2 • Data samples spanning sufficiently long time series • Sound back-testing practices • Special regulatory and supervisory consideration of Low Default and Low Data Portfolios • Internal and Regulatory Stress testing • Good quality supervision and consistently applied supervisory standards • Similar for internal Model Validation
Incentive-Compatibility issues	• Use test compliance ensuring that internal risk management is aligned with regulatory capital models; signals derived from internal models to senior management about riskiness of portfolios will need to be accurate to avoid mispricing and unexpectedly high losses • Introduction of remuneration standards and associated internal policies which are aligned with risk measures; long term views are promoted by claw back provisions and bonus deferral • Pillar 2 • Good quality supervision and consistently applied supervisory standards • Similar for internal Model Validation
RWA inconsistency and dispersion	• Reduction of undue RWA variance as per work conducted by the Standard Implementation Group Banking Book (SIG BB) and TFSC groups, EBA, European Central Bank (ECB) Single Supervisory Mechanism (SSM) and IIF RWA Task Force • Regular benchmarking exercises combined with back testing • Enhanced RWA-related transparency leading to better market

	discipline as per proposals of Pillar 3 WG, EDTF and IIF RWA Taskforce
Low level of Models-based RWAs	• Leverage ratio *will* become a binding constraint for growing low-risk portfolios • Pillar 2 will tackle the possibility of undue concentration • Use test requirements and Pillar 2 to ensure that risk and pricing are aligned • Systemic risk and countercyclical buffers are in place for cases where this is symptomatic in a jurisdiction • Internal and Regulatory Stress testing • Good quality supervision and consistently applied supervisory standards. This includes heightened model validation standards • Perceived as problematic mostly in mortgages and sovereign exposures: the LGD floor and the review of sovereign exposures already tackle that.
Horizontal inequity in RWA SA-IRB	• Use of full historic data for calibration of both SAs and internal model approaches • Revisiting SA aimed at making them as risk sensitive as possible • SA banks should remain incentivized to move to more sophisticated risk measurement and management approaches as supported by internal models

Appendix 2 – List of Associations

Institute of International Finance: The Institute of International Finance, Inc. (IIF) is a global association created in 1983 in response to the international debt crisis. The IIF has evolved to meet the changing needs of the international financial community. The IIF's purpose is to support the financial industry in prudently managing risks, including sovereign risk; in disseminating sound practices and standards; and in advocating regulatory, financial, and economic policies in the broad interest of members and foster global financial stability.

Members include the world's largest commercial banks and investment banks, as well as a growing number of insurance companies and investment management firms. Among the IIF's Associate members are multinational corporations, consultancies and law firms, trading companies, export credit agencies, and multilateral agencies. All of the major markets are represented and participation from the leading financial institutions in emerging market countries is also increasing steadily. Today the IIF has more than 450 members headquartered in more than 70 countries. For more information, please visit www.iif.com.

Global Financial Markets Association: The Global Financial Markets Association (GFMA) brings together three of the world's leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe (AFME) in London and Brussels, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian and North American members of GFMA. For more information, visit http://www.gfma.org.

International Swaps and Derivatives Association: Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 67 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

The Commercial Real Estate Finance Council: The Commercial Real Estate Finance Council (CREFC) is the trade association for lenders, investors and servicers engaged in the $3.2 trillion commercial real estate finance industry. More than 250 companies and 5,500 individuals are members of CREFC. Member firms include commercial banks, insurance companies, private equity funds, mortgage REITs, investment grade and B-piece buyers, servicers and rating agencies, among others. CREFC promotes capital formation, encouraging commercial real estate finance market efficiency, transparency and liquidity. In addition to its member Forums, committees and working groups, CREFC acts as a legislative and regulatory advocate for the industry, plays a vital role in setting market standards and provides education for market participants in this key sector of the global economy. For further information, please visit http://www.crefc.org.