14 April 2016

Mr. Stefan Ingves
Chairman, Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2, CH-4002
Basel, Switzerland

Re: Basel Proposal - Reducing variation in credit risk-weighted assets
constraints on the use of internal model approaches

Dear Mr. Ingves:

We are writing to express our concerns about the Basel Committee’s recent consultative document proposing to restrict significantly the use of internal models. While we will be responding in detail to the consultation, we wanted to write early in the process given the importance of the proposals, and the potential damage they could do.

In a lacklustre global economic environment, and in the absence of a comprehensive assessment of the economic impacts of the Basel 3 financial reform agenda, we question whether it is wise to introduce proposals that will jeopardise corporates’ access to finance. We also note that end-users in jurisdictions with less developed capital markets and faced with significant investment and funding requirements are likely to be among those most impacted. We urge the Committee to carefully consider its proposals in this context.

We understand that the objectives of the proposals are to (i) reduce the complexity of the regulatory framework and improve comparability; and (ii) to reduce excessive variability in the capital requirements for credit risk. The paper does not mention the importance of maintaining a risk sensitive capital framework. By omitting this as a clear objective, we are deeply concerned that the Basel Committee is prepared to sacrifice the risk based framework developed over the last 30 years.

We strongly believe that the objectives set out in the paper can be achieved without the need significantly to restrict internal modelling in the way proposed. We disagree with the Committee’s judgment that its approach is justified by its assessment of the costs and benefits of permitting banks’ internal models to drive regulatory capital calculations. In particular, we believe that the Committee’s approach is disproportionate and difficult to reconcile with a capital framework intended to be proportionate to underlying risk levels.

We understand that the consultation is ongoing and final calibration decisions are yet to be made. However, our worry is that the consultation represents a retrograde conceptual shift in the design of the international framework. This is reinforced when considered alongside other proposals to revise the Standardised Approaches for the various risk categories and to introduce output capital floors.
Assessments that are made internally by banks allow for the most accurate measurement of risk. They also enable banks to make the most efficient capital allocation and pricing decisions, which benefit their customers. Banks evaluate their activities and allocate capital based on returns on regulatory requirements which are their binding constraint. Those regulatory capital requirements need to be based, as closely as possible, on underlying risk levels. Relying on regulators’ assessments of risks, which will be rough approximations at best, to determine capital would be a major step backwards. Ultimately, it could also lead to less diversity in banks’ portfolios, with a corresponding increase in risk to the financial system as a whole. In order to ensure a financial system that measures risk accurately, allocates capital accordingly and provides sound origination incentives that benefit the economy at large, risk sensitivity must remain a core feature of the capital framework.

This does not mean to say that banks should have absolute freedom in their internal modelling of risk. It is of course necessary for non-risk based variability in RWA outcomes to be reduced to the absolute minimum. This requires technical approaches to be consistent and comparable across firms. Firms need to adopt appropriate margins of prudence in their parameter estimates. And modelled outcomes need to be back-tested and disclosed with the right level of detail for proper market discipline. In parallel, supervisors must ensure rigorous and continued oversight of models and proper governance of those models within firms. Significant efforts and investments have been made, by both firms and regulators at international level and in major jurisdictions of the Basel Committee, to ensure that such controls are effective. It is also worth recalling that the lion’s share of RWA variability is risk-based. Moreover, as the Committee is well aware, the leverage ratio already acts as a binding backstop to risk based capital requirements, addressing concerns about modelling risk.

GFMA stands ready to work together with the international regulatory community to ensure that we have a well functioning international capital framework. Financial stability is in the interests of all. We are however deeply concerned that, by reducing the role of risk sensitivity in the framework, the Basel Committee is moving in a direction that will do severe damage to the prospects for growth in the world economy.

Sincerely,

Kenneth E. Bentsen, Jr.
CEO
Global Financial Markets Association

cc: Bill Coen