March 27, 2015

Comments on the Basel Committee on Banking Supervision’s Consultative Document
“Capital floors: the design of a framework based on standardised approaches”

Japanese Bankers Association

We, the Japanese Bankers Association (JBA), would like to express our gratitude for this opportunity to comment on the consultative document *Capital floors: the design of a framework based on standardised approaches* issued by the Basel Committee on Banking Supervision (the BCBS).

We respectfully expect that the following comments will contribute to your further discussion.

<<**1: General Comments**>>

✧ Comments on whether to introduce capital floors

(1) We do not support the introduction of capital floors.

(2) We particularly and strongly disagree with the RWA floor based on stanrdardised approaches.

✧ Comments on the proposed capital floor framework, should it be determined to be implemented

(1) It should be defined that the objective of capital floors is to prevent the underestimate of RWAs.

(2) Capital floors should be set at a minimum level needed to prevent the underestimate of RWAs.

(3) The timeline to publish the final rule should be extended.

(4) Capital floors should be applied at the same time of, or after, the application date of the revised standardised approach.

(5) Adequate transitional measures should be provided in consideration of impact of capital floors on the real economy.

✧ Comments on whether to introduce capital floors

(1) We do not support the introduction of capital floors.

First of all, we would like to point out that the objectives of the proposed capital floor framework differ from the original objective of the capital floor framework, which was to function as a transitional arrangement to mitigate the impact of drastic changes caused by the implementation of the Basel II. To our understanding, the primary objective of this proposal is to reduce excessive variability in regulatory capital ratios. Since the objective has changed, it should be carefully considered whether it is appropriate to take the same approach with that under the previous framework.

According to paragraph 11 of the Consultative Document, the objectives of capital floors include:

(i) preventing undue optimism in bank modelling practices, thereby ensuring that modelled capital requirements do not fall below a prudent level;
(ii) mitigating model risk due to such factors as incorrect model specification, measurement error, data limitations and structural changes that may not be captured in historical data;
(iii) addressing incentive-compatibility issues, as banks face incentives to use overly optimistic internal models to reduce risk-weighted assets and thereby maximise return on equity;
(iv) improving comparability by providing a standardised assessment of risk which can be compared against internal model-based outcomes; and
(v) constraining variation in model-derived risk-weighted assets (RWAs) that arises from differences in bank and supervisory practices, thereby improving the comparability of RWAs across banks and over time.

However, the relationship between the above five issues and a single approach of setting capital floors is unclear. Various other approaches that would be more appropriate to address the respective issues should be considered.

For example, before considering the introduction of capital floors, the BCBS could explore other approaches that address above objective (i), such as supervisory oversight and implementation of back testing. Similarly, it should be considered that the objectives (ii) to (v) could be fulfilled by improving internal modelling or other approaches before considering of introducing capital floors. More specifically, the BCBS should consider addressing the above issues through, among other things, the clarification of standards of internal model approval, a certain degree of standardisation of parameter estimation methods used in the internally modelled approaches, supervisory coordination across jurisdictions, gap analyses using an average of RWAs provided by third-party providers as a benchmark, expansion of the scope of disclosure by banks related to internal models and verification by supervisors.

In the first place, it is not considered to be discreet and sophisticated to conclude that capital floors would be able to meet five different objectives (i.e. to solve five issues having different causes) without exploring other various appropriate measures which address those five different causes. Thus, we do not support the proposed approach.

Further, the scheduled introduction of the leverage ratio should be taken into account. The above issues (i) through (iii) should be addressed by the introduction of the leverage ratio as stated in paragraph 57 of the BCBS's discussion paper "The regulatory framework: balancing risk sensitivity, simplicity and comparability" (issued in July 2013; bcbs258) as one of its important benefits (*). Introducing capital floors for the purpose of preventing underestimate of RWAs or mitigating model risk will mean to impose duplicate regulations for the same purpose.

(*) The leverage ratio "reinforces the risk-based requirements with a simple non-risk based "backstop" that provides a floor to the outcome of risk-based capital requirements which provides a protection against model risk and the reduction of capital requirements via the optimistic use of models and parameters".

(2) We particularly and strongly disagree with RWA floor based on standardised approaches.

We strongly disagree with the capital floors based on standardised approaches because it would undermine risk measurement based on the internally modelled approach, as discussed below.

The internally modelled approach is more risk sensitive, precise and appropriately reflect banks' risk profile compared to the standardised approach.

The standardised approach, on the other hand, has an advantage in its simplicity but is inferior to the internally modelled approach in terms of risk sensitivity and precision because it is based on certain assumptions. Further, while the internally modelled approach is capable of precisely measuring the risk amount of a variety of risk assets included in banks' portfolios in accordance with characteristics and risks of respective assets, the standardised approach inevitably derive less precise outcomes because it is based on broader categories and definitions. Therefore, if the capital floors based on standardised approaches should be introduced, depending on the level of such floors, risk sensitive and precise risk measurement based on internally modelled approach may be undermined.

In addition, even if the capital floors based on the standardised approach are introduced despite the approach's lack of capability to adequately reflect differences of risk characteristics across banks and jurisdictions, it may not enhance the comparability of risks inherent in banks but rather may obscure risks and thereby impair comparability. This would eventually undermine market discipline and prompt hidden risks to be accumulated, resulting in another systemic risk to emerge.

✧ Comments on the proposed capital floor framework, should it be determined to be implemented

(1) It should be defined that the objective of capital floors is to prevent the underestimate of

RWAs.

It should be defined that the objective of capital floors is to prevent the underestimate of RWAs. Without a definite objective, it is difficult to identify causes and essence of issues to be addressed and to consider specific measures to address the issues. If excessive variability in regulatory capital is the fundamental issue, the objective of introducing capital floors should be prevention of the underestimate of RWAs (i.e. the above-mentioned objective (i)).

(2) Capital floors should be set at a minimum level needed to prevent the underestimate of RWAs.

With regard to the calibration of the floor, which is mentioned to be considered by the BCBS later, capital floors, if introduced for the purspose of preventing underestimate of RWAs, should be set at a minimum level so that such floors will not result in de facto regulatory RWAs for banks using internal models; otherwise the floors may give rise to unintended adverse effects as described in the following.

First, we would like to discuss from the viewpoint of ROE. ROE is calculated by multiplying return on assets (i.e. profits/total assets) by financial leverage (i.e. total assets/capital). Financial leverage is constrained by the leverage ratio and hence an increase in the amount of total assets will be limited. Therefore, banks need to increase return on assets under the limited size of total assets for improving ROE. If however capital floors are introduced, since assets with a lower risk would receive a higher risk weight under the standardised approach, banks would have no incentive to have a preference to hold lower-risk assets and enhance the quality of assets. As a result, to pursuit profits, banks would increase investments in high-risk and high-return assets, whose risks cannot be adequately captured by the standardised approach.

Secondly, if the floors are introduced at the level that substantially undermines internally modelled approaches, the significance of maintaining and developing internal models with a burden of resources and cost will be lost, which may reduce banks’ risk management capabilities and also compromise the stability of the banking system.

If the BCBS determines to introduce a capital floor, other approaches should be considered, for example an approach to set minimum capital requirements according to RWAs on which the floor is based, instead of directly regulating the RWA level.

(3) The timeline to publish the final rule should be extended.

Although the Consultative Document excludes the calibration of the floor from the scope of this consultation and only covers the design of a capital floor framework, it is difficult to solely consider the reasonableness of the design because both design and calibration relate to each other closely.

At present, aside from this discussion related to the design of a capital floor framework, it is understood that the BCBS is implementing and considering the review of standardised approaches and internally modelled approaches for each risk category.

Private-sector financial institutions need to comment on individual issues by respective due dates under the circumstances where it is unclear as to what kind of framework will be formed through a series of these regulatory reforms as a whole. While a simple and versatile standardised approach that is applicable to small-sized banks is deemed as preferable; if it is assumed that the capital floors based on standardised approaches will be introduced, improvement of risk sensitivity and accuracy of the standardised approach will be deemed as necessary. Further, as exemplified earlier that some of the objectives of the capital floor framework overlaps with that of the leverage ratio framework, the BCBS should give due regard to ensure consistency across all relevant regulations. Otherwise, the fallacy of composition may arise where an approach that is appropriate under individual discussions may be inappropriate in the context of the whole regime.

A series of the aforementioned regulatory reforms have a significant impact on the risk-based capital framework and may completely change the existing capital ratio and risk management practices. Given this, the BCBS is requested to take sufficient time to have a dialogue with the private sector and give careful consideration to the impact these regulations as a whole may cause on financial institutions and the real economy.

In this view, it would be premature to publish the final rule by the end of 2015 as per current timeline. The BCBS should at least implement the second consultation on the capital floor framework after its review of standardised and internally modelled approaches for each risk category is completed.

(4) Capital floors should be applied at the same time of, or after, the application date of the revised standardised approach.

Capital floors, if introduced, should be applicable at the same time as, or after, the standardised approach currently under review becomes effective. If capital floors are applied before that, banks may be imposed inappropriate capital requirements during a period of transition. Further, if banks are required to calculate the floors based on the existing standardised approach, it will be inefficient for them and also require additional cost to develop systems based on the approach that is scheduled to be revised in the future.

(5) Adequate transitional measures should be provided in consideration of impact of capital floors on the real economy.

Depending on the level of capital floors (factor), if the new regulation is fully implemented without any transitional measures, RWAs may increase significantly, violating the capital floors, at many banks, instantly giving rise to the reduction in capital ratios. This could lead to increased credit uncertainty of depositors and investors against banks. An impact on the real economy therefore should be considered very carefully and adequate transitional measures should be provided.

<<**<u>2: Responses to Questions</u>**>>

Q1. Assuming the respective floors were calibrated to achieve the same level of required capital, what are your views on the relative merits of a risk category-based floors and an aggregate RWA-based floor? What are your views on a floor based on exposure class?

As described in our general comments, we do not support the introduction of capital floors. However, should the BCBS determine to introduce the floors, the objective of capital floors should be to prevent the underestimate of RWAs, namely, to prevent some banks from having lower levels of capital than they should do. Given this objective, capital floors, if introduced, should be a very simple framework and an aggregate RWA-based floor would be enough to fulfill the objective.

We understand that the introduction of risk category-based floors is intended to address risks of each model or the issue of comparability, but consider that they are not an issue to be addressed by the capital floor framework, as argued in our general comments.

Further, even if risk category-based floors are introduced based on the standardised approach, it will not solve the issue because the standardised approach has low risk sensitivity and does not sufficiently reflect the difference in characteristics across jurisdictions.

In addition, a floor based on more granular asset classes should not be introduced in relation to, for example, credit risk. Even under current practice, the outcomes of standardised and internally modelled approaches do not fully match, if constraints with regard to guarantee or collateral and off-balance sheet netting (offset of deposits) are different. Given that the classification of asset is different among two approaches and there are cases where calculations of RWA are different for one exposure, it would be extremely difficult in practice to establish capital floors based on asset classes. Moreover, in some cases, it may provide an arbitrage opportunity in deciding which exposure class a floor should be based on.

Q2. What are your views on the relative merits of the two options for adjusting for differences in the treatment of provisioning for credit risk?

Given that the objective is to adjust for differences in the treatment of expected losses (EL) and provisions in relation to credit risk, understandability should be pursued and RWAs (Option 2), instead of capital (Option 1), should be adjusted.

If Option 1 is adopted, capital ratios are calculated by applying provision-adjusted capital as the numerator and RWAs based on the standardised approach as the denominator, and each of them are compared. In this case, the assessment for the necessity to apply a floor is required for CET1 ratio, Tier 1 ratio and total capital adequacy ratio, respectively. If it is assessed that a floor needs to be applied only to some of these ratios, a situation where two types of RWAs exist may arise, making it difficult for external related parties, such as investors, to understand. This will undermine the intention of a series of regulatory framework review.

Q3. Do you have any other comments regarding the design of the capital floor?

We strongly disagree with application of capital floors that are based on the revised standardised approach particularly to operational risk because the revised standardised approach for operational risk does not take into account risk sensitivity and does not reflect the complexity of the business model.

If it should be determined that a floor will be applied to operational risk, RWAs, which the floor is based on, should be calculated based on an indicator that better reflects risk profile (e.g. historical internal loss), rather than the standardised approach, because that would exactly meet the essential objective of the capital floor, which is to prevent underestimate of risk. Further, it is considered that variability in the outcomes of an advance measurement approach (AMA) can be addressed by, for example, ensuring consistency across the approaches such as consistency of correlation between the measurement units.