Global Risk Regulator

A PUBLICATION FROM THE BANKER

February 2015 | Volume 13, Issue 2

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Obama: Unravelling Wall St reforms will earn my veto

Increasingly vocal Democrat opposition, threats of a presidential veto and pre-election politics all stand in the way of Republican efforts to roll back Wall Street reforms. *Charles Piggott* reports

In his January State of the Union speech, president Barack Obama again warned that any attempts at "unravelling the new rules on Wall Street" would "earn my veto". Two weeks later, releasing the 2016 Budget the White House again said it would fight attempts to roll back Wall Street reform, increase funding for regulatory agencies and place a seven basis point tax on the liabilities of banks with more than $50bn in assets (see *GRR*, p12).

With the Republicans now holding a majority in both houses of Congress, this may be fighting talk. With the exception of just two senators, Republicans voted en masse against the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Barack Obama

Jeb Hensarling, chairman of the House Committee on Financial Services and senator Richard Shelby, who returned to chair the Senate banking committee in January, both publicly opposed Dodd-Frank and have in the past supported bills to repeal major parts of it.

Few actually think the Republican leadership will go all out for a full repeal of Dodd-Frank. Paul Kupiec, resident scholar at the American Enterprise Institute, says political rhetoric coming into the election cycle is beginning to influence regulatory *to page 4*

Basel must tread carefully on risk-weight floors

Bank regulators must perform a delicate balancing act if standardised approaches are to work as a backstop to internal capital models.
By Philip Alexander

In December last year, the Basel Committee on Banking Supervision (BCBS) proposed a potentially far-reaching change to the way that banks measure their assets for the purposes of calculating the Basel capital ratios. This is the idea that standardised approaches used for calculating the risk weights assigned to assets could become floors for the outputs of banks' own internal models. The concept was first signalled by BCBS chair Stefan Ingves in his update letter to ministers of the G20 nations in November 2014.

"Internally modelled risk weights lead to capital not keeping pace with asset expansion. This has undermined the confidence in banks and the credibility of the concept of banks' internally modelled risk weights. Ensuring consistency in the implementation of risk-based capital standards will therefore be a key factor in restoring confidence in banks," Mr Ingves said in a speech in the same month.

Stefan Ingves

With just nine pages of text, the first consultation paper published a month later does not put much flesh on the bones. It sets out the twin targets of ensuring an adequate minimum level of capital in the banking system and improving the accuracy of models, without going into much detail on the case for a standardised floor.

At the heart of the debate over the floor concept is the tension between making the calculation of risk-weighted assets (RWAs) simple to monitor, and making them *to page 6*

Basel must tread carefully on risk-weight floors

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sensitive to the actual risk of the assets. The calibration of the floor will be essential to maintaining this balance, and on this matter the consultation presented questions rather than answers.

"When we talk about less risk sensitivity, what that means in practice is less recognition for how effectively the bank is managing risk – for collateral management, netting and modelling," says Simon Brennan, a senior manager in the Deloitte Europe, Middle East and Africa Centre for Regulatory Strategy.

To be decided

During the transition from Basel I to Basel II, the BCBS set a floor that specified risk weights under Basel II should not fall below 80% of what the Basel I level would have been. The exact percentage of the proposed standardised approach floor will be specified only after a quantitative impact study (QIS) in 2015.

So too will a closely related question – whether the floor will apply on aggregate across the bank, or to each specific category of risk for which both standardised

Eduardo Epperlein
"We should not forget that some banks that suffered the largest losses during the crisis relied on standardised approaches"

and internal ratings based (IRB) or internal model approaches (IMA) exist to calculate RWAs. Those categories consist of credit, market, operational, counterparty and banking book securitisation risks.

For the standardised RWA floor, it is virtually impossible for banks to assess the impact of a given calibration until the QIS, and a decision between aggregate or individual floors. The BCBS is also planning to review the leverage ratio, which was originally set at a minimum of 3% of total unweighted assets but could be revised upward. In its work programme for 2015 to 2016, published in January 2015, the BCBS pledged to examine in detail the "interaction, coherence and overall calibration" of this new, multi-layer capital framework.

"If the leverage ratio becomes a binding constraint, banks would be much less likely to base business decisions on the results coming out of risk models. A standardised approach floor would be more risk-sensitive, but there is a limit to how far that can go, so there are still some of the same concerns," says Jermy Prenio, deputy director of regulatory affairs at the Institute of International Finance.

Models here to stay

Even if the floor is calibrated relatively high, industry participants do not expect banks to abandon internal models, despite the IT infrastructure and staff costs of maintaining and validating models. The models are vital to pricing and risk management, but there could be a potential disconnect with capital management.

"Standardised approaches may play a larger role in capital management, but in terms of setting internal risk appetite, bespoke internal models will still have a very important role. The question is going to be how risk managers explain the divergence between those two when communicating the numbers to the board," says Panayiotis Dionysopoulos, director of risk and capital at the International Swaps and Derivatives Association.

Mr Brennan believes regulators themselves are keen to preserve a role for models, as part of their continuing drive to improve general risk management in large financial institutions. In its January 2015 progress report on adoption of its principles for effective risk data aggregation and risk reporting (BCBS239), the BCBS found that "many banks continue to encounter difficulties in establishing strong data aggregation governance, architecture and processes". Consequently, Mr Brennan would expect regulators to express concern if banks using internal models were to dispense with them altogether.

"For many business models, what may change is that the size and complexity of the balance sheet at which it would make sense for a bank to invest in new models will rise," he says.

However, Eduardo Epperlein, global head of risk methodology at Japanese investment bank Nomura, warns that standardised floors could introduce new risks even if models are here to stay. In particular, the standardised approach is not subject to the same kind of validation and back testing requirements that every bank has to apply to their internal models. Regulators would need to review the standardised inputs, but this is unlikely to happen as frequently as the supervisory process at a bank. And a floor could limit the incentives for banks to improve internal models, so there will be greater

Simon Brennan
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reliance on the regulatory formulae being correct.

"That introduces a potential systemic risk if every bank is constrained by a high floor based on a standardised approach that turns out not to perform well. We should not forget that some banks were relying on standardised approaches to assess some of the products that suffered the largest losses during the crisis, such as super-senior [collateralised debt obligations]," says Mr Epperlein.

One size fits all

A few BCBS member countries already have experience of applying RWA floors to internal models on an ad hoc basis. One of those is Mr Ingves' home country, Sweden, which introduced a 15% RWA floor for Swedish residential mortgages in May 2013, increased to 25% a year later.

Uldis Cerps, executive director for banks at Sweden's financial supervisor Finansinspektionen, says it is difficult to draw general conclusions from the Swedish experience that might inform the BCBS debate. For instance, he is unsure whether a standardised approach floor for credit risk would be a suitable replacement for the bespoke mortgage RWAs arrangement introduced by the Finansinspektionen in 2013.

"When we set a floor for mortgage risk weights, it was carefully calibrated for Sweden, whereas the global floor calibration will be appropriate for the average cross-border bank. It remains to be seen whether the calibration in the standardised approach, which will apply to all Basel Committee member states including emerging markets, is also appropriate for mature mortgage markets in Western Europe," says Mr Cerps.

He has a firmer view on the choice between aggregated or individual floors. As suggested by Sweden's focus on the mortgage segment, Mr Cerps tends to favour a more granular approach, perhaps even extending as far as separating each category of exposures – sovereigns, financial institutions, corporates and retail.

"If there is a single floor, it is possible for banks to arbitrage high risk in some exposures with low risk in others, which is not necessarily conducive to financial stability, so it is better to backstop each asset class on its own. A more granular approach will also allow us to look at the calibration of each backstop and decide if there is a sufficient number of buckets and risk drivers in the standardised approach for each category," he says.

This path chimes with the initial thinking in the industry. Trade associations expect that individual floors will be more risk-sensitive than the aggregated approach. That consensus could break down, however, once banks begin to assess their own QIS results.

"From the QIS on the new standardised approach for counterparty risk [in 2014], we know that it affected banks very differently depending on their portfolio type and the products and direction in that portfolio. The same is likely to be true for the floor overall: some banks would benefit from individual floors, some would be better off under the aggregate approach," says Alex Szmigin, a senior manager in the risk and regulation team at Deloitte and former prudential supervisor at the UK Financial Services Authority.

Co-operative approach

The scale of uncertainty for banks and national regulators is further intensified because the BCBS is still consulting on revised standardised approaches for credit, market and operational risk at the same time as the floor consultation. These revisions will take the debate right to the heart of the Basel balancing act.

The standardised approaches were originally devised as a simple method suitable for smaller, less sophisticated banks with less complex business models, for which internal methods were not cost-effective. But if standardised approaches are also to serve as floors for internal models, the largest banks will want a substantial say in the revised design.

That has already happened with the development of a new standardised approach for calculating market risk. In October 2013, the BCBS proposed a cash flow approach that was universally criticised across the industry because it bore little resemblance to how banks structure and risk-manage their trading desks.

The industry co-operated with the BCBS Trading Book Group (TBG) to devise a new sensitivities-based approach (SBA). This was published for consultation in December 2014, and has met a number of the concerns generated by a QIS on the new market risk framework conducted in September 2014.

In particular, the TBG took a new approach to basis risk (the risk that the relationship between the prices of two correlated instruments weakens over time). It has replaced a fixed disallowance factor that proved to be a major cause of overstated capital requirements during the September QIS. While these technical improvements are welcome, the overall

Uldis Cerps
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impact of the new standardised approach will only become clear with the next QIS, scheduled for the first half of 2015.

"In the past the Basel Committee has expressed a desire not to alter the total amount of capital in the system, but modified this by saying that the potential capital requirements for certain asset classes may change. This could translate into potentially large differences opening up between asset classes, with FX and interest rate risk benefiting in the sensitivities-based approach to market risk, while credit and securitisations are potentially heading toward higher capital charges. Unless thoughtfully calibrated, using the SBA as a floor could trigger a further exit by banks from credit trading inventories," says Martyn Brush, the head of risk for Corporate and Institutional Banking at RBS.

One global bank has apparently calculated that the capital treatment of credit under the SBA could be 10 times more penal than that of FX, although this is not

Bernard Colla
"If banks want to trade financial instruments, they need adequate pricing models"

necessarily a consensus view in the market. A further concern is the potential decoupling of individual trades from matching hedges under the SBA.

"That runs the risk that banks will start to hedge the accounting balance sheet by entering into trades that are not justifiable from an economic or risk management point of view," says Arnold Veldhoen, an associate partner at Avantage Reply and former risk manager for an Australian bank.

Given the double significance of the SBA as a potential floor for internal models, Mr Prenio is concerned that the end-2015 deadline for its completion should not lead to undue haste in the design stage.

"The fundamental review of the trading book is so complex that it would help if the QIS was divided up to focus on certain aspects rather than doing it holistically. In the 2014 QIS there were some data quality issues, so it would help both the banks to produce the data and the regulators to analyse it if the QIS were done in phases," he says.

Big is beautiful?

This technical challenge of testing the new market risk framework again raises the vital question of simplicity. Is the SBA still suitable as the core methodology for smaller banks, rather than purely as the backstop for IMA banks?

"The new sensitivities approach is certainly much easier to work with than the previous proposal for a standardised approach that would have forced banks to model all their cash flows, but it is still more difficult for smaller banks to calculate the sensitivities for each instrument in the trading book than for large ▶

IMA institutions. One could argue that, if banks want to trade financial instruments, they need adequate pricing models in any case," says Bernard Colla, a senior manager at consultancy Avantage Reply and former head of market risk management for a Belgian bank.

Mr Epperlein says he is not aware of concerns about complexity at this stage from banks that rely on the standardised approach to market risk. A key constituency is likely to be the largest investment banks based in emerging markets such as Brazil, which have not generally made the transition to IMA.

"In practice, an emerging market bank may want the more granular calibration of the SBA, because it is more exposed to risk factors in its home market that may be less significant for banks based in more mature markets," says Mr Epperlein.

Mr Brush suggests the use of a standardised floor might create a more level playing field among dealers by limiting the capital advantages of internal models enjoyed by the largest banks. But that would not alter his view of the value of internal models.

"The SBA should allow smaller banks, which cannot afford a large quant team and related resources, a real improvement in the prospects for running activities in the service of their customers. But existing IMA banks would not want to run their trading desks purely using SBA, which – while increasing intuition about risk over the current standardised approach – would be a degradation of existing tools available to them. For instance, SBA does not easily lead to identification of second-order correlation risks across the bank; the most obvious of these are credit and funding valuation adjustments, which can only really be understood by dynamically changing assumptions," says Mr Brush.

Alex Szmigin
"It could be argued that there is an opportunity to implement a simpler standardised approach for smaller banks"

Fundamentally, he warns, there is a delicate balance for regulators to achieve: incentivising spending on continual improvements in risk management through opportunities for capital efficiency, versus a one-size-fits-all approach that, although simpler to regulate, may not capture the full breadth of risks.

Credit where it's due

The dilemma of balancing the interests of IRB and simple banks is even more marked for credit risk, because this is the core business of almost all banks, whereas many smaller institutions do not have significant financial market trading activities. There are three or four central elements to the revised standardised approach to credit risk proposed in December 2014.

RWAs for credit to corporate and financial institutions are to be calculated using leverage and revenue indicators rather than external credit ratings. A single 35% risk weight for mortgages is to become more granular, based on loan-to-value and affordability (debt service to income) ratios. There will be a special focus on commercial real estate, and a distinction between senior and subordinated debt that did not previously exist.

"In the past six years, we experienced the financial crisis and performed a series of stress tests, enabling a significantly more accurate calibration of credit risk weights for the entire banking system. The new iteration of the standardised approach has borrowed the most important risk drivers from the internal risk models, so it is more risk-sensitive, while remaining simpler than IRB," says Anton Treialt, a senior consultant at Avantage Reply and a former head of group credit risk at pan-Baltic group Hansabank.

At first sight, the revisions will be especially favourable for mortgage lending and loans to small and medium enterprises (SMEs) – two of the core business lines for smaller banks in mature and emerging markets. Mortgage lending was the segment that tended to show the largest advantage for banks that adopted IRB, which will now be at least partially corrected. The use of loan-to-value and affordability data also fits well with emerging macro-prudential regulation such as that in the UK. SME lenders have long complained about the reliance on external credit ratings in the original standardised approach.

"There are many exposures that have no external rating, so the credit risks for SMEs were not being clearly differentiated under the previous standardised approach. There is also a potential virtuous circle if corporates are required to provide more information than in the past for their banks to calculate credit risk weights, particularly outside the G20 countries where accounting can be opaque," says David Richardson, head of quantitative advisory at consultancy Parker Fitzgerald and a former risk modeller in the UK banking sector.

Anton Treialt
"The new iteration of the standardised approach has borrowed the most important risk drivers from the internal risk models"

However, Mr Prenio notes that there could still be capital distortions for corporate lending if corporate credits are divided up into revenue buckets that are applied universally as drivers for credit RWAs. "This could put emerging markets at a disadvantage, because corporates there have smaller markets and so by their nature they have lower revenues, but they could still be large by the standards of that market," says Mr Prenio.

Mr Richardson observes a potential implementation challenge to the proposed standardised approach for mortgages. Banks are required to have loan-to-value and affordability data as at loan origination. Smaller banks are unlikely to retain such historic data, and may need a reasonable transition period to improve their data capture processes. Mr Szmigin at Deloitte believes smaller banks will also face operational difficulties over the requirement to use non-performing asset data to calculate risk weightings for inter-bank exposures, which is not currently available in their systems in many cases.

"The standardised approaches have been revised in part because of their proposed role as floors for larger banks using modelled approaches. It could be argued that there is an opportunity to implement a simpler standardised approach for smaller banks, for instance when the Basel rules for internationally active banks are transposed into EU legislation for a broader range of national credit institutions," says Mr Szmigin. GRR