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Global Regulatory Network Executive Briefing

Global Regulatory Network

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Basel Committee report on RWAs for the banking book

The Basel Committee on Banking Supervision (BCBS or the Committee) has published a report on the consistency of risk weightings for banking book assets generated by the internal ratings-based (IRB) mechanism developed under Basel II.[1] This follows on from a report in January on the consistency of the risk-weighted assets (RWAs) for trading assets, which had raised issues about unexplained RWA variability across banks.[2] The more recent report is based on a study of the supervisory data for more than 100 global banks. The overall conclusion is that there is significantly less unexplained variability in banking book RWAs than was observed in the trading book. This could have an important impact on the debate around imposing additional constraints on banks' internal measurement approaches, however, the outcome will also be influenced by the separate debate on the balance between risk sensitivity and simplicity, a topic on which the Committee has asked for comments on a discussion document.

Although the degree of variation found for the banking book was similar to that found for market risk, in contrast to the trading book review, three quarters of banking book variation reflected differences in the risk profile of banks' loan books. This type of variation in the underlying risk profile of banks' lending portfolios is precisely what a risk-sensitive capital framework is intended to detect.

Other key findings include:

- Of the 25% variation not explained by differences in credit books, eight percentage points are due to regulatory adjustments – the use of floors for certain parameters or portfolios or partial use of the standardized approach. Other regulatory-driven differences were found as well.

[1] Press releases," *Bank for International Settlements website*, www.bis.org/press/p130705.htm, accessed 15/July/2013
[2] Press releases," *Bank for International Settlements website*, www.bis.org/press/p130131.htm, accessed 15/July/2013

Building a better working world

- The study captured different asset mixes in banks but could not capture the relative riskiness of those particular assets across banks (i.e., whether some banks focused on higher risk borrowers in an asset class or had less credit risk mitigation). Therefore this too will be a driver of risk weighting differences. Also, differences in choice of foundation or advanced approaches drove some variation.
- The remainder of the differences reflects bank-specific modeling decisions, an important part of which was the addition of conservative buffers to some parameters.
- For low-default portfolios, a study using a hypothetical portfolio was conducted with 32 participating banks. The rank ordering of borrowers was very similar across banks, but there were variations in granularity of rating scales and parameters. Loss given default (LGD) was a core area of difference, particularly for sovereigns, which is not surprising given the limited recoveries experience in this area.

Assessment

The study does not confirm the wide unexplained variation in Basel capital ratios implied by some external studies that have compared Basel capital ratios for individual banks with their tangible equity-to-assets ratio. It highlights the importance of considering portfolio composition and the importance of understanding the factors influencing the results for different banks. LGD was the area of greatest variability, but there are reasons for this. For example, many banks were using broad bands of borrowers to calculate LGD and the composition of these bands varied across banks. LGDs also reflected different banks' workout practices and credit risk mitigation techniques.

Regulatory actions and IRB implications

The Committee confirmed the need for the capital framework to retain its risk sensitivity and also acknowledged that variations in banks' assessments of risks are helpful from a financial stability viewpoint.

Clearly, though, it is important for RWAs to be better understood. In the short term, the Committee's focus will be on enhanced disclosure. But the Committee also wants to reduce unwarranted variation, and here different interpretations of the rules may be playing a role and greater clarity in some areas will be considered. In the medium term, the Committee will likely examine the potential to harmonize national implementation regulations and put additional constraints on IRB parameters, for example, by using benchmark values. But in that regard, the Committee noted that more work on RWA variation looking at more granular information on portfolio composition and credit risk mitigation will be needed.

Examples of areas for possible additional guidance regarding the IRB:

- Adjustment of IRB parameters for conservatism or cyclical effects
- Use of external data for low-default portfolios

Examples of areas where more harmonization might be sought in national implementation:

- Capital floor adjustments
- Partial use of standardized approach
- Definition of default
- Treatment of defaulted exposures
- Exemptions from the one-year maturity floor
- Requirements related to the estimation of parameters

As noted, a separate task force of the Committee has been considering the balance between risk sensitivity and simplicity, but this work is at an early stage. The Committee has recently released a discussion paper and is asking for comments.[3]

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[3] Press releases," *Bank for International Settlements website*, www.bis.org/publ/bcbs258.htm, accessed 15/July/2013.

Global Regulatory Network

EY's Global Regulatory Network is an integral part of our Financial Services Office and enables EY to offer banks deep experience, leadership and insights on financial regulation.

Our global regulatory services are led by an executive team of former senior regulators, including former Basel Committee Secretary General Stefan Walter. This team, supported by more than 100 other former regulators, drives EY's strategic outlook on global regulatory themes impacting global banks, including capital, liquidity, resolution and recovery planning, risk governance and other emerging topics in banking regulation.

Stefan Walter was secretary general of the Basel Committee on Banking Supervision from 2006 to 2011. During this time, he was also a member of the Financial Stability Board. He has more than 20 years of international bank supervisory experience, including 15 years at the Federal Reserve Bank of New York.

Dr Tom Huertas is a former member of the FSA's Executive Committee. He also served as alternate chair of the European Banking Authority, as a member of the Basel Committee on Banking Supervision and as a member of the Resolution Steering Committee at the Financial Stability Board.

Patricia Jackson is the former head of the Bank of England Regulatory Policy. She was the head of the Financial Industry and Regulation Division from 1995 to 2003 and was a member of the Basel Committee from 1995 to 2003. She chaired the global Quantitative Impact Studies to test the effect of Basel II and chaired the Calibration subgroup.

Don Vangel, Regulatory Advisor to the Office of the Chairman, joined EY after a 17-year career at the Federal Reserve Bank of New York where he ultimately served as a Senior Vice President for Bank Supervision.

Urs Bischof is the former head of Risk Management of the Extended Executive Board of Switzerland's FINMA. His responsibilities included risk management supervision and oversight and prudential regulations, along with leadership roles with respect to Basel III, SIFI regulation, payments and clearing.

Marie-Helene Fortesa has extensive regulatory experience. Her posts have included leadership roles at the Autorité de Contrôle Prudentiel (French Prudential Supervisory Authority), the Association Française des Banques (French Banking Association) and INSEE (French National Institute for Statistics and Economic Studies), as well as senior roles at a leading investment bank.

John Liver's experience includes a number of regulatory roles with leading investment banks as well as the UK FSA and its predecessors. His roles include head of thematic supervision in the Investment Firms Division, head of Personal Investment Authority Supervision, overseeing the sales regulation of the life and pensions industry, and management roles in Investment Management Regulatory Organization's Enforcement and Supervision Departments.

Phil Rodd, Keith Pogson and **David Scott** have extensive experience working with regulators across the Asia-Pacific region. **Hidekatsu Koishihara** is a former chief inspector and Inspection administrator for the Japan Financial Services Agency. He also worked at the Ministry of Finance of Japan (MOF), Japan's former financial regulator, serving as the financial inspector at the Bank Bureau of MOF and Financial Inspection Division, and Minister's Secretariat of MOF.

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