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**Finance Watch response to EBA's Discussion paper on Future of the IRB Approach**

Brussels, 4 May 2015

Finance Watch is an independent, non-profit public interest association dedicated to making finance work for society. It was created in June 2011 to be a citizen's counterweight to the lobbying of the financial industry and conducts technical and policy advocacy in favour of financial regulations that will make finance serve society.

Its 70+ civil society members from around Europe include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs. To see a full list of members, please visit www.finance-watch.org.

Finance Watch was founded on the following principles: finance is essential for society and should serve the economy, it should not be conducted to the detriment of society, capital should be brought to productive use, the transfer of credit risk to society is unacceptable, and markets should be fair and transparent.

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Only the questions that are relevant to Finance Watch are reproduced here.

For further questions, please contact Paulina Przewoska, senior policy analyst at Finance Watch, at paulina.przewoska@finance-watch.org.

**General remarks**

Finance Watch welcomes the European Banking Authority's (EBA) initiative to consider a more fundamental review of the Internal Ratings-Based (IRB) Approach. We acknowledge the fact that some of the ideas suggested cannot be implemented without legislative initiatives by the European institutions and hence could be achieved only in the medium term. However we also agree with EBA that it is important to recognize the changes are needed and therefore we allow ourselves to make a few comments in this respect.

As EBA rightly notes in the Consultation Document, the main incentive for banks to implement the IRB Approach is still the potential gain in terms of lower capital requirements. In other words for banks it is often a cost minimization exercise which, as history shows, can be very distortive.

Currently, EBA's work concentrates on the comparability and reliability of internal models taking into account the need to reduce variations in average Risk Weighted Assets, which are driven by bank practices.

Please note that whilst Finance Watch appreciates the intention of decreasing bank reliance on external ratings through the IRB Approach we also find that it still provides an unfair advantage to large banks (who are able to offset the costs of implementation) over small banks for which the burden is too high or the data not available. Moreover, the current Basel Committee on Banking Supervision (BCBS) proposals are aimed at removing the reliance on external ratings within the Standardized Approach (SA), hence both of the approaches will contribute to reducing reliance on external ratings and this advantage of IRB over SA should disappear in the future.

More generally, models are imperfect and whilst they might be a useful additional decision-making tool, it is always under a certain restrictive set of assumptions. The model complexity and uncertainty can lead to dramatic risk overshooting. Whether it is caused by managers' inability to understand the models set up by so-called 'quants' or by the temptation to forget restrictive limitations when business is profitable, it should be ensured that management fully understands the limitations of quantitative risk measures.[1] Moreover, as Andy Haldane puts it: *"if the financial environment is uncertain, complex risk-weighting may be sub-optimal".*[2]

As the OECD puts it in *its Economic Surveys: Euro Area 2014,* some of the empirical approach indicates that risk weighted capital ratios have not been good predictors of market measures of risk. *"To some extent this might reflect Goodhart's law which states that when a measure becomes a target its quality declines".*[3] Moreover *"banks' ability to arbitrage the capital weights to reduce capital and expand leverage is very extensive. If the leverage ratio is set too high (capital required too low), banks will have an incentive to arbitrage the weights to ensure they do not hold any more capital than needed."*[4]

[1] Please refer to our position paper on CRD IV: *To end all crises?*
[2] Andrew G Haldane: *The dog and the frisbee*
[3] OECD, *Economic Surveys: Euro Area 2014*
[4] A. Blundell-Wignall, P. Atkinson: *Thinking beyond Basel III: Necessary Solutions for Capital and Liquidity*, OECD, 2010.

Therefore, we welcome also the BCBS's aim to review the structure of the regulatory framework including considerations of the costs and benefits of basing regulatory capital on banks' internal models and alternative approaches to determining regulatory capital.[5]

Bearing in mind the shortcomings of internal models, arising mostly from model uncertainty, complexity and regulatory arbitrage, Finance Watch is convinced that the regulatory framework should not rely on them as a major Pillar 1 indicator of capital. A simple leverage ratio has been shown to be a much better predictor of banks' distance to default.

Therefore, until a major re-think regarding the role of internal models and risk weighted capital ratios is accomplished, **it is important to introduce a leverage cap as a binding Pillar 1 measure** and to keep the Basel I floor or introduce the Standardized Approach floor (provided that it will not result in a softened prudential treatment) as put forward by the BCBS.

2. What would you consider the areas of priorities?

We strongly support setting the harmonization of the definition of default as a priority, since this is the variable that contributes most to the divergences in Risk Weighted Assets (RWA). It is an urgent matter and we welcome the EBA workstream in this respect.

However, the Credit risk mitigation (CRM) provisions should not be seen as a low regulatory priority, especially taking into account the possibility of regulatory arbitrage and the general consequences for financial stability resulting therefrom. Please refer to our answer to question 15 below for more details.

8. Do you consider the direction of the proposed changes adequate to address the weaknesses and divergences in the models across institutions?

EBA refers to detailed technical changes in the IRB framework concerning the modelling of risk parameters (such as the treatment of multiple defaults, default rates, probability of default (PD) estimation and loss given default (LGD) estimation and downturn adjustments of LGD and conversion factors) as changes which should address the weaknesses and divergences in the models across institutions. While the proposed changes go in the right direction, we believe that truly addressing the weaknesses of the models would require simplifying the models more fundamentally. Please refer also to our general comments above.

The competent authorities will verify whether or not the risk parameters are estimated according to the rules developed under the Single Rulebook. We acknowledge that the Single Supervisor should contribute to reducing major divergences in the models across institutions. However, given the number of banks under single supervision, the diversity of internal models and their complexity, in practice it will take the Single Supervisor a decade to accomplish this task.

[5] BCBS, *Reducing excessive variability in banks' regulatory capital ratios.* A report to the G20, November 2014.

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Moreover, in Finance Watch's opinion, the transparency requirements, such as disclosures from the benchmarking exercise and the RWA calculated under the Standardized Approach for IRB banks, will have a strong positive impact by reducing divergences and enhancing understanding of banks' risk management.

| 15. Do you agree that CRM is a low priority area as regards the regulatory developments? |
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Finance Watch does not agree. It should be a high priority in terms of regulation.

As EBA rightly notes in the Consultation Document "the *Credit risk mitigation (CRM) provisions are perceived as one of the most complex and unclear parts of the Basel framework due to large variety of requirements and methods. This complexity impacts also the IRB Approach as it is not always clear which CRM requirements apply to which methods of calculating the capital requirements. In the opinion of EBA a fundamental review of the CRM framework is necessary, in order to clarify it and include the current experience in the application of these rules.*" The CRM framework includes a large variety of possible methods with regard to use of collateral.

BCBS wants to address this complexity and opacity. In its workstream covering credit risk internal models it is working on the simplification and harmonization of a credit risk mitigation framework, with the aim of finishing this at the end of 2015.

It is worth noting that the CRM framework has further adverse consequences for financial stability since it allows banks to engage in regulatory arbitrage. In complete credit markets banks can short credit with other banks (via Credit Default Swaps) replacing the PD (or LGD in the case of the advanced IRB method) of borrower with lower PD (or LGD) of the other bank. If the other bank underwrites the risk with a reinsurance company, it will also recognize the insurance[6] as part of the CRM framework – decreasing the capital requirements and the exposure to the initial borrower will "migrate" outside the banking sector, whereas the capital requirements regulation (CRR) does not longer account for this exposure outside of banks. [7]

The CRR framework does require banks to have in place systems to manage the potential concentration of risks arising from the use of guarantees and credit derivatives, but the requirements are general and subject to supervisory discretion (compare e.g. article 213 of CRR).

[6] EBA stated in its Q&A that insurance might qualify as an eligible guarantee: "*A credit insurance might qualify as guarantee. The eligibility criteria for the recognition as guarantee can be found in Articles 399 and 403 of Regulation (EU) No. 575/2013 (CRR) in connection with the referenced requirements laid down in Part Three, Title II, Chapter 4 of CRR. The requirements set out in Article 201 CRR (eligibility of protection provider), Article 213 CRR (general requirements for unfunded credit protection) and Article 215 CRR (additional requirements for guarantees) are of particular importance*."
http://www.eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2014_768

[7] Based on the example provided in A. Blundell-Wignall, P. Atkinson, *Thinking beyond Basel III: Necessary Solutions for Capital and Liquidity,* OECD, 2010.

As A. Blundell- Wignall and P. Atkinson put it in one of the OECD studies: "*There is a massive incentive in financial markets to use "complete market" techniques to reconfigure credits as capital market instruments to avoid capital charges and reduce tax burdens*." [8]

The consequences are two-fold – the ex-ante determination of risk weights through risk buckets (under the standardized approach) will not remain stable over time since it can be changed by the CRM techniques. The risk shifts to the other parts of the financial system leaving the banking system inadequately capitalized. Moreover, the CRM increases the interconnectedness of banks. Lastly, the crisis has shown that the CRM techniques are not always effective as the AIG Financial Products case clearly proved.

Therefore Finance Watch is convinced that simplification of the CRM framework and ensuring the robustness of this framework from the financial stability point of view is a major issue rather than a low regulatory priority. We urge EBA to recommend the Commission to legislate in this area.

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| 17. Do you agree that the area of disclosures needs to be strengthened, in particular with regard to disclosures related with the benchmarking exercise, for instance by publishing them on the EBA website? |

We strongly support the implementation of mandatory disclosures regarding the benchmarking exercise. Although the benchmarking exercise is by definition a limited exercise that will not offer a comprehensive view of possible excesses and discrepancies, it is nevertheless an important exercise whose results should be available to all interested stakeholders.

As EBA rightly notes in the Consultation Document, the main incentive for banks to implement the IRB Approach is still the potential gain in terms of capital requirements.

Therefore, we do see merit in mandatory disclosures of RWA calculated under the standardized approach for IRB-banks, in order to achieve greater transparency and enhance comparability. In addition, the harmonization of the exposure classes for the purpose of the IRB and standardized approach, as currently put forward by the BCBS, would also bring positive results in this respect.

Banks might argue that harmonization of the exposures will compromise the flexibility and granularity of internal models. However, we do not think that harmonizing the exposures for disclosure purposes, would have negative effects on banks' risk management systems. It would require mapping IRB exposures to SA exposures.

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| 21. How would you ensure appropriate use of the IRB Approach in a harmonized manner without excessive concerns of the so called 'cherry picking'? |

[8] Ibid.

In order to increase the possibility for small banks to use the IRB Approach, we would suggest allowing them to use the IRB Approach **only for SME exposures**, provided they can demonstrate that this partial use is not done for 'cherry picking' purposes but because of material constraints.

Please also refer to our general comments above on internal models and the implications of internal models for smaller institutions.

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| 22. Do you see merit in moving towards the harmonization of the exposure classes for the purpose of the IRB and the Standardized Approach? |

Yes, we support the harmonization of the exposure classes for the purpose of the IRB and standardized approach as it will increase comparability and transparency.
This idea is supported by the current BCBS workstream on the revision of the standardized approach for credit risk. The BCBS indicates as one of the aims of the revision increasing the comparability of capital requirements under the standardized approach and internal ratings-based approach by aligning definitions and taxonomy, where possible.

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| 25. Are there any other aspects of the IRB Approach not discussed in this document that should be reviewed in order to enhance comparability of the risk estimates and capital requirements? |

Please refer to our general remarks above.