INSTITUTE OF INTERNATIONAL FINANCE

IIF Risk and Regulatory Capital Symposium, December 3, 2015

The IIF was pleased to host a Risk and Regulatory Capital Symposium in New York on December 3. Conducted under Chatham House rule, the Symposium involved a range of participants from regulators and the industry, as well as consultants and academics.

The major themes discussed in the Symposium are summarized as follows:

Credit Risk modeling: The role of credit risk modeling in setting regulatory capital requirements was discussed extensively, including the value of risk-sensitivity and the downstream uses of capital metrics in pricing and incentives. The level of excessive variance between banks' RWA calculations was acknowledged, with efforts such as the IIF RWA Task Force's 78 harmonization recommendations intended to help address this. On the regulatory side, discussions about the need to introduce further constraints to the IRB framework through tools such as minimum floors for risk parameters was also suggested as a solution. Investors' demand for greater transparency and comparability was discussed, whether that might necessitate the use of floors, disclosure of Standardized calculations, and the disclosure of modelled calculations under global standards (to address nation-level variances).

Market Risk: Similar to credit risk, the challenges of excessive variance were discussed, including the extent to which these reflect legitimate underlying differences, with the IIF RWA Task Force's 20 harmonization recommendations aiming to help convergence without unduly compromising areas of legitimate difference. One regulator observed that banks should only be allowed to run trading books if they have demonstrable modeling sophistication.

Operational Risk: Several commentators focused on the significant shortcomings of the AMA approach, attributing this to the problem of trying to deal to a very high confidence interval and the extreme events presented as tail risks. One suggestion was that such modeling could have value in trying to measure the risks in the middle of the distribution, perhaps if calibrated to only a 95% confidence interval. Blunt indicators (such as those based only on size) might be too basic, and there could be a diminished role for models to help deal to the middle of the curve, recognizing the inadequacies for tail risks. While many advocated the view that AMA should be replaced, participants agreed that deciding what other framework should replace it was something that required further consideration. The potential benefits that insurance can provide as a risk mitigant for operational risk were also raised, as well as the role of insurance in promoting better management of operational risks.

RWA and Other Capital Measures: It was reiterated that the Leverage Ratio is intended as a backstop, with some industry participants then questioning whether the Capital Floor proposal (based on revised Standardized approaches) would duplicate this, questioning why a second backstop would be needed. A number of industry participants complained of the challenge and complexity of having too many intersecting or overlapping capital measures, whilst others focused more on the calibration and which of these measures would be the binding constraint. There were mixed experiences related as to whether banks are finding themselves bound by the Leverage Ratio or by stress testing measures such as CCAR, with views that non-risk sensitive measures drive wrong behaviors. Participants discussed that stress testing has raised capital requirements higher to cover for systemic risks (beyond the single institution) with consequential downstream impacts that have affected pricing.

Pricing and incentives: It was described that banks had held capital pre-crisis to levels of their own choosing (above low regulatory minima) that were clearly insufficient, and that since then banks have uplifted their own perceived level of what's required, but regulatory levels have gone even higher. As such, banks are now each managing to regulatory capital requirements, meaning that there is a critical need to ensure that the basis by which regulatory capital requirements are set is appropriate and conducive to the right behavioral signals. There was a broad consensus that banks are now increasingly conducting their pricing on the basis of regulatory capital, not economic capital. A bank that operates under the Standardized Approach for regulatory capital (and had been aspiring to IRB accreditation) related their experience of trying to price to economic capital, and finding that this inevitably relies on cross-subsidization and the use of unstable scaling factors that are invariably unsustainable.

Other Behavioral Considerations: The potential for gaming through internal models manipulation was discussed, with some participants observing that it is easiest to game a simpler approach, particularly in the current environment where model approval and validation (often at the desk level) is extremely rigorous. Similarly, some participants related examples of the arbitrage opportunities that existed (and were exploited) under such simpler approaches, including the previous Basel I regime. The risks of herd mentality and increased systemic risk if all banks follow a single non-risk sensitive approach were also described.

Future Policy Making: Participants also discussed their views on the type and content of the policy making necessary to address issues such as RWA variance, the revised role for internal models in setting regulatory capital as well as the desire to balance simplicity, comparability and risk sensitivity in regulatory capital. A number of regulators argued that there needs to be recognition that their concerns about financial stability and the need to ensure adequate capital levels to prevent future crises might not always be aligned with the natural interest of private firms to ensure adequate levels of profitability. Industry participants argued that systemic stability was a shared concern and that risk sensitivity in regulatory capital was a goal in line with that concern to the extent that incentives ought to be based on risk to be able to drive the right behaviors. In this regard, the industry noted a great deal of concern about reduced risk sensitivity in many of the policy proposals that have been announced. Regulators also indicated that the Basel Committee continues to consider what the right mix of policies between revised standardized approaches (which could act as a backstop of internal model risk), a system of capital floors, a revised leverage ratio and further constraints to the IRB framework were necessary to ensure their goals.

Market liquidity: A number of banks highlighted their concerns on diminished market liquidity, as per the study that PwC had undertaken on behalf of the IIF and GFMA earlier in the year. The impact of flat capital measures (such as the Leverage Ratio) over-stating the risk associated with highly-rated liquid assets was cited as a contributing factor.

The Symposium provided a fruitful discussion on each of these themes, and the IIF will continue to look for further opportunities to facilitate such dialogue with the Basel Committee as the debate on the future of the Internal Rating Based (IRB) approach proceeds in 2016.

The IIF will also continue its agenda on pursuing ways to help reduce RWA variance, with specific work on the Point-in-Time and Through-the-Cycle approaches to Probability of Default currently in train.

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