November 20, 2015

Mr. Mario Draghi
Chairman
Group of Governors and Heads of Supervision (GHOS)
Bank for International Settlements,
Centralbahnplatz 2, CH-4002 Basel
Switzerland

Mr. Stefan Ingves
Chairman
Basel Committee on Banking Supervision (BCBS)
Bank for International Settlements
Centralbahnplatz 2, CH-4002 Basel
Switzerland

Dear Chairman Draghi and Chairman Ingves:

Ever since the formation of the Basel Committee on Banking Supervision, one of its core objectives has been to promote financial stability and reduce the incidence of misallocation of credit in the global economy by improving the alignment of regulatory capital requirements with underlying risk. Notwithstanding periodic setbacks, the evolving regulatory capital framework has undoubtedly served both to improve resource allocation and, more importantly, reinforce the primacy of risk-based capital allocation for over two generations of senior bankers.

The recent global financial crisis drew attention to weaknesses in some areas of risk modeling and misaligned incentives. The regulatory reform program over the last seven years has addressed the most significant failings. In particular, the recalibration of capital support for structured products, the revisions to the definition of capital and the introduction of new buffers, the introduction of far more rigorous stress testing, the enhancement of liquidity requirements together with the introduction of standardized liquidity ratios and the augmentation of macro-prudential toolkits have all buttressed the Basel Committee's objective of better aligning capital support with underlying risk.

We understand that, among other ongoing initiatives, the Basel Committee is considering the basis for a review of the IRB approach to address known weaknesses and concerns over variability of model outcomes. We would like to offer the global banking industry's perspective on this important debate and also to highlight what the industry has done to help address underlying issues of concern.

The IIF strongly believes that it is critical to keep risk-sensitivity at the center of the capital framework. This belief is driven by the industry's judgment that risk sensitivity is the best way to minimize the misallocation of resources by instilling in banks' decision-making processes the primacy of aligning capital support with risk of loss. Long term divergence between

regulatory capital frameworks and underlying economic risks is bound to have serious adverse consequences. In the post-crisis period, when many economic sectors in both developed and emerging markets still highly rely on banks as the main source of funding, reducing the alignment of capital and risk could negatively and unnecessarily affect the availability and pricing of credit to the economy.

Accordingly, whilst recognizing that the role of internal models needs to be revised and the transparency and predictability of outcomes improved, we wish to express our deep concern about the direction that the proposed strategic reconsideration of the Basel capital framework might take.

Keeping risk sensitivity in the Basel framework is of vital importance for safety and soundness. If capital requirements are excessively standardized, without adequate risk-differentiation, the end result will be further homogenization of banks' balance sheets and position taking, with negative implications for system stability and market liquidity.

Furthermore, a risk-sensitive capital framework is essential to ensure that the appropriate incentives are permeated throughout firms, reinforcing the desired risk-consciousness. Without such framework, there is a heightened risk of misallocation and adverse selection in banks' portfolios, with pricing reflecting false incentives and performance management potentially misleading as to risk appetite utilization. For risk and capital management to provide valuable behavioral incentives, sophisticated risk measures need to be enhanced and embedded throughout institutions, not cast aside or allowed to be overridden.

While we maintain that internal models should continue to play a critical part in the regulatory capital framework, the IIF accepts that the level of unexplained variation between individual banks' RWA calculations needs to be reduced and that improvements to the IRB framework are therefore necessary. Although the BCBS's 2013 Regulatory Consistency Assessment Programme (RCAP) attributed most variance to genuine underlying factors, we agree nonetheless that the overall level of variance needs to be narrowed. [1]

As a support to regulatory policy makers, the IIF RWA Task Force undertook a comprehensive review in 2014. Forty three banks took part in a thorough exercise to examine risk modeling practices. This exercise identified a range of sources of variance between banks' internal models, which can be categorized into three broad groups: [2]

- national factors, including domestic laws governing insolvency and credit collections, accounting treatments, taxation, and particular market or country-specific factors;

- inherent differences between banks, reflecting distinct risk practices, policies and the fact that portfolios are not homogeneous; and

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[1] Basel Committee on Banking Supervision, *Regulatory Capital Assessment Programme (RCAP) – Analysis of risk-weighted assets for credit risk in the banking book*, July 2013. This report identified that three-quarters of RWA variance for credit risk reflects "underlying differences in the risk composition of banks' assets", with one-quarter attributable to variations in bank and supervisor practices. It also identified that, when normalizing for portfolio differences, 69% of IRB-accredited banks calculated risk-weights that were within 10% of a central mean, with the remaining outliers falling within a 20% range.

[2] The substantial insights generated from this exercise were documented in our IIF Risk Weighted Assets Task Force Final Report, which was shared with regulators in November 2014, and has subsequently served as an input for some regulators' review activities, including at the European Banking Authority. The IIF RWA Task Force's analysis was complemented by numeric impact analysis undertaken by Global Credit Data, which helped to identify which parameters and modeling assumptions contributed the most to the overall quantum of variance.

- where banks, within the scope of existing regulation and supervisory guidance, have made varying assumptions and used different parameters and inputs in the course of their modelling approaches.

We accept these categories are not exclusive and that there are some clear areas of overlap: the objective of any reform must be to preserve genuine underlying differences in assessment of individual credits, while significantly improving the harmonization of modelling techniques in areas and factors where risk differentiation is not warranted.

In support of these principles, the banks who took part in our study agreed to a diverse suite of recommendations addressing where banks' modeling assumptions and parameters could be harmonized. These included 78 recommendations in the area of credit risk, and 20 around market risk modeling. Delivery of this harmonization agenda would still see some level of variance. But it would narrow the scope of variance to those underlying differences between dissimilar banks and known, jurisdiction-specific, differences in national legal, insolvency and accounting frameworks and local market idiosyncrasies, which could be transparently disclosed.

Building on the substantial work undertaken by the IIF RWA Task Force and the BCBS, we believe there should usefully be a greater degree of dialogue between the BCBS and the industry on the range of alternative approaches to solving RWA variance. Rather than discard the IRB approach we believe a more productive agenda could address the material sources of undue RWA variance, thereby improving the IRB framework.

The industry remains committed to reducing RWA variance and to increasing transparency of risk internal metrics. We see this as a necessary part of the continuous improvement of models. We don't make this statement lightly, knowing that the implementation of a harmonization agenda will be a substantial, arduous and costly undertaking, particularly where banks have large historical data sets that have been constructed in particular formats. We recognize this is essential if the industry is to restore the credibility of the IRB framework.

We accept there are indeed limitations on the effectiveness of models, but there are even now many areas and scenarios where banks' models have proven highly effective. We draw attention to the Moody's 2014 review which supported the predictive performance of RWA based on banks' internal models through the crisis.[3] The same study observed that banks' models were calibrated conservatively, so that they commonly over-stated observed default and loss rates across various asset classes.

We also note that the leverage ratio has been consistently described by the Basel Committee as a "supplementary" or "backstop" measure.[4] The industry continues to support its inclusion within the Basel framework on that basis, noting that if it is calibrated at a proper level, it will serve as an effective back-stop without impeding the role of risk-sensitivity as a behavioral driver.[5]

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[3] Moody's Investor Service, 2014, *Proposed bank rating methodology*.

[4] Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems*, December 2010 and June 2011.

[5] Joint Associations (GMFA, ABA, FSR, IIB, IIF & ISDA) *Comments in Response to the Consultative Document on the Revised Basel III Leverage Ratio Framework and Disclosure Requirements*, September 20, 2013.

However, if it is calibrated at a disproportionately high level, the leverage ratio instead will overwhelm the risk-based approach and will become the binding constraint. The same applies for capital floors, if those are based on a Standardized Approach that relies on an inadequate set of risk-drivers.

In conclusion, we strongly believe that internal models can and should be improved, rather than abandoned or over-ridden by simplistic standardized measures. As risk-based models have been developed, validated and refined over the last decade, banks and supervisors alike have accumulated considerable experience, helping to enhance how risk is measured and managed. Such experience and value should be retained to provide the basis of a sounder and enhanced IRB framework.

Importantly, a less risk-sensitive framework would have variable impacts on a number of important developing and developed economies that should not be neglected. Thus, there is a risk of further fragmentation in support for the Basel framework if countries and regions focused on rebuilding economic growth are asked to implement further regulatory reforms that are seen as constraining the ability of the banking system to support that growth.

Banks use capital metrics as a key input in their business strategies, pricing, performance management and investment decisions. So changing the dynamics of capital allocation is not merely an issue of determining which form of measurement might be optimal in and of itself. It is rather a shared objective to incentivize the desired behaviors at the point of risk origination and to ensure that banks have a capital consciousness at grass-roots level that is linked to overall bank strategy and risk appetite. To deliver this, 'top-of-house' capital adequacy consideration should be aligned with the capital measures used throughout the organization in day to day decision making, as indeed is required under the Use Test.

The preservation of risk sensitivity is so critical to banking that the industry and supervisors must collectively take up the challenge to improve models and restore the credibility of the IRB framework. The global industry, through the IIF, and supported by banks' available risk management expertise, stands ready to continue working with the regulatory community on this important goal. We look forward to discussing with you specific ways to move ahead with this urgent task.

Sincerely,

Timothy D. Adams
President and CEO

Douglas Flint
Chairman of the Board

Attachment: List of members of IIF Board of Directors