BCBS Regulatory Framework – Balancing Risk Sensitivity, Simplicity and Comparability


The Basel Committee on Banking Supervision released a Discussion Paper to initiate discussion on the topic of balancing risk sensitivity, simplicity and comparability within the Basel capital standards. The Basel Committee, in response to the financial crisis that began in 2007, introduced a number of reforms to substantially raise the resilience of the financial system to shocks. While some of these measures strengthen the bank capital adequacy framework itself, others are designed to complement it in ensuring the soundness of banks.

To read the full Discussion Paper (27 pages), please click here.

These measures include the introduction of a leverage ratio, an additional capital surcharge for global systemically important banks (G-SIBs), a proposed framework for measuring and controlling large exposures, and minimum liquidity and funding standards. The Basel Committee has also introduced a comprehensive regulatory consistency assessment program with a view to ensuring consistent implementation of Basel III across banks and jurisdictions. (See also our “Sector Flash – BCBS on Complexity of Financial Regulation – 1 July 2013”).

In addition to these reforms, during 2012 the Basel Committee commissioned a small group of its members (the Task Force on Simplicity and Comparability) to undertake a review of the Basel capital framework. The goal of the Task Force was to identify opportunities to remove undue complexity within the framework, and improve the comparability of its outcomes. The creation of the Task Force acknowledged that the framework has steadily grown over time as risk coverage has been expanded and more sophisticated risk measurement methodologies have been introduced.

The paper being released discusses the reasons behind the evolution of the current framework, and outlines the potential benefits and costs that arise from a more risk sensitive methodology. The paper also discusses ideas that could possibly be explored to further reform the framework with the objective that it continues to strike an appropriate balance between the complementary goals of risk sensitivity, simplicity and comparability.
Regulatory & Accounting Briefing

The purpose of the discussion paper is to seek views on this critical issue so as to help shape the Basel Committee's thinking. At this stage, the Basel Committee has not made a decision to pursue any of the ideas presented; the paper is being published to elicit comments and feedback from interested stakeholders, which will help the Basel Committee refine its thinking in this area.

Furthermore, the Basel Committee remains firmly of the view that full, timely and consistent implementation of Basel III remains fundamental to building a resilient financial system, maintaining public confidence in regulatory ratios and providing a level playing field for internationally active banks. Adopting the Basel III reforms (higher and better quality capital, improved risk coverage, capital buffers, and liquidity and funding requirements) in accordance with the internationally-agreed transition period deadlines is itself an important step in improving the consistency of bank regulation globally.

Mr Stefan Ingves, Chairman of the Basel Committee and Governor, Sveriges Riksbank said: "The Basel Committee is keenly aware of the current debate concerning the complexity of the current regulatory framework. For that reason, the Basel Committee set up a Task Force last year to look at this issue in some depth. The Basel Committee believes that it would benefit from further input on this critical issue before deciding on the merits of any specific changes to the current framework. The paper being released today is designed to encourage discussion among, and solicit views from, a broad set of stakeholders."

The Basel Committee welcomes views on the issues outlined in this paper. Comments should be submitted by Friday 11 October 2013 by e-mail to baselcommittee@bis.org. Alternatively, comments may be sent by post to: Secretariat of the Basel Committee on Banking Supervision, Bank for International Settlements, CH-4002 Basel, Switzerland. All comments may be published on the website of the Bank for International Settlements unless a respondent explicitly requests confidential treatment.

Conceptual considerations

Simplicity

Simplicity is a design feature of a regulatory framework. In the context of the capital adequacy framework, it has two dimensions: the simplicity of the capital standard itself, and the simplicity of the capital calculation process.

A capital standard is simple if it is clear and can be understood with reasonable effort. This requires:

- **Simple exposition**: a simple standard is clearly expressed in straightforward language. It is easily explained to banks to which it is meant to apply, as well as to other groups with a legitimate interest, such as market analysts.

- **Simple interpretation**: a simple standard is precise and unambiguous: it avoids imprecise terms that are capable of widely divergent interpretations.

A capital calculation process is simple if it requires:

- **Simple inputs**: a simple standard does not require a large number of inputs and avoids reliance on inputs not captured within the normal accounting or risk management
systems of banks (i.e., the inputs are subject to internal or external validation so the
data called for is more readily accessible, better understood, and more reliable).

- **Simple calculations**: a simple standard can be calculated without the need for the use of
highly advanced mathematical and statistical concepts, avoids iterative calculations, and
can be easily verified by external parties such as supervisors or auditors.

**Impediments to simplicity within the current framework include:**

- increased focus on the risk sensitivity of capital requirements, which in turn is driven by
multidimensional risks and the diversity of modern financial instruments to which banks
have exposures;

- basing measurement of capital requirements on banks’ internal models, which are
continuously evolving to reflect advances in risk management;

- efforts to avoid different interpretations of certain terms and achieve precision that may
result in additional or more specific criteria;

- the need to reflect the specific circumstances of all member jurisdictions, which leads to
the expansion and complexity of the globally agreed standards; and

- the need to provide a range of options to measure capital requirements, keeping in view
the varying stages of development of different financial systems.

**Comparability**

**Comparability** is an outcome of a regulatory framework. A capital framework achieves
perfect comparability if it delivers:

- **Comparability between banks**: two banks with portfolios having identical risk profiles
apply the framework’s rules and arrive at the same amount of risk-weighted assets and
two banks with different risk profiles should produce risk numbers that are different
proportionally to the differences in risk.

- **Comparability over time**: a bank’s risk-weighted assets do not change over time if the
underlying risks remain unchanged, and change proportionally when risks do change.

- **Comparable information**: any differences in risk-weighted assets across banks,
jurisdictions and over time can be understood and explained.

**Impediments to comparability within the current framework include:**

- calculational complexity, which makes it harder to understand the drivers of changes in
risk-weighted assets;

- choices given to banks (e.g. choices between advanced and standardized approaches,
and modeling choices within the advanced approaches);

- differences in interpretation of information and differences in the level of conservatism
applied by banks (e.g. value adjustments/provisions, rating grades, and estimates of
PD/LGD);

- choices given to supervisors (e.g. national discretions); and
– differences in measurement and valuation regimes, including in particular accounting frameworks.

■ Risk sensitivity

Risk sensitivity can be both a design feature and an outcome of a regulatory framework. In the context of capital requirements these two different dimensions can be thought of as:

– **Ex ante risk sensitivity**: a risk-sensitive standard draws fine distinctions based on the characteristics of individual exposures or transactions. In the capital adequacy framework, this is primarily reflected in the granularity of the risk weights.

– **Ex post risk sensitivity**: a standard is risk-sensitive if, other things being equal, it can accurately differentiate in advance between different risk profiles. For a capital framework, this implies that it can distinguish with reasonable accuracy between sound banks and those that are likely to fail. Risk is, of course, unobservable; hence, this type of risk sensitivity can only be accurately assessed ex post.

■ Impediments to ex ante risk sensitivity within the current framework include:

– the multidimensional nature of risk in complex banking organizations, which makes comprehensive risk assessment extremely challenging;

– the limits to data collection, storage and analysis; and the need to offer simple approaches for a range of different banks.

■ Impediments to ex post risk sensitivity include:

– the use of risk models, simplified representations of reality built on assumptions that may fail;

– the nature of risk itself, and the inability to predict the future with certainty; and

– the possibility that indicators may lose their predictive power when relied on for regulatory purposes (Goodhart’s Law).

■ [Full text](<click here>).

■ ………

■ (Source: Basel Committee on Banking Supervision – BCBS).

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