World Council of Credit Unions

June 23, 2016

Filed electronically
William Coen
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002
Basel, Switzerland

Re: Consultative Document: *Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches* (March 2016)

Dear Mr. Coen:

World Council of Credit Unions (World Council) appreciates the opportunity to comment on the Basel Committee on Banking Supervision's consultative document *Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches*.[1] Credit unions are cooperative depository institutions and World Council is the leading trade association and development organization for the international credit union movement. Worldwide, there are 57,000 credit unions in 105 countries with USD 1.8 trillion in total assets serving 217 million natural person members.[2]

World Council supports the Basel Committee's proposals to reduce the complexity and variability of the Basel III internal ratings based (IRB) approaches, including through the establishment of capital floors based on the standardised approach. Specifically, World Council supports this consultation's proposals to:

- Remove the option for large banks to use the IRB approach for exposures that cannot be reliably estimated, such as in the case of specialized lending exposures;
- Adopt exposure-level, model-parameter floors; and
- Provide greater specification of parameter estimation practices to reduce variability in risk-weighted assets for portfolios where the IRB approaches remain available.

Some national supervisors have elected to apply the Basel III standardised approach to credit unions, mutual banks and mutual building societies even though these Basel standards are only mandatory for banking institutions that operate on a cross-border basis (and credit unions and other mutuals rarely operate on a cross-border basis). In these jurisdictions, large banks following IRB approaches are generally allowed to put aside significantly less capital than standardised approach institutions against similar assets, such as residential mortgages.

[1] Basel Committee on Banking Supervision, *Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches* – Consultative Document (2016), *available at* http://www.bis.org/bcbs/publ/d362.pdf.
[2] World Council of Credit Unions, *2014 Statistical Report* (2015), *available at* http://www.woccu.org/publications/statreport.

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These regulatory capital arbitrage opportunities under the IRB approaches give the world's largest banks even greater competitive advantages over smaller institutions than they would otherwise enjoy based on their greater economies of scale and implicit state-backing.

Restricting the ability of the world's largest banks effectively to write their own capital rules under the IRB approaches is in the public interest both in terms of promoting financial stability as well as in terms of reducing large banks' unjustified competitive advantages vis-à-vis smaller institutions following standardised approaches.

In Australia, for example, the recent governmental Financial System Inquiry found that large Australian banks employing the IRB had assigned risk-weights to their mortgage holdings that required much less capital than institutions following standardised approaches are required to hold against similar Australian mortgages.

Specifically, Australia's Financial System Inquiry concluded that IRB risk-weightings should be increased so that they are more consistent with standardised approach risk-weightings:[3]

> [The Australian Prudential Regulation Authority] APRA should adjust the requirements for calculating risk weights for housing loans to narrow the difference between average IRB and standardised risk weights. This should be achieved in a manner that retains an incentive for banks to improve risk management capacity. It should also appropriately recognise the differences in the risks captured by IRB and standardised risk weights.
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> The average mortgage risk weight for an [Authorised Deposit-taking Institution] ADI using the standardised model is currently 39 per cent — more than twice the size of the average mortgage risk weight for banks using IRB models, which is 18 per cent.
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> IRB risk weights are lower for many reasons, including because this method reflects a more refined calculation of the risks at IRB banks. However, the Inquiry notes that the principle of holding capital relative to risk should apply, not only within an institution, but also across institutions. In the Inquiry's view, the relative riskiness of mortgages between IRB and standardised banks does not justify one type of institution being required to hold twice as much capital for mortgages than another. This conclusion is supported by the findings of APRA's recent stress test, which found regulatory capital for housing was more sufficient for standardised banks than IRB banks.
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> The gap between average IRB and standardised mortgage risk weights means IRB banks can use a much smaller portion of equity funding for mortgages than standardised banks. Because equity is a more expensive funding source than debt, this translates into a funding cost advantage for IRB banks' mortgage businesses to the extent that the riskiness of mortgage portfolios is similar across banks.

[3] Financial System Inquiry, *Final Report* at 60-62 (Dec. 2014), *available at* http://fsi.gov.au/publications/final-report/,

> Given that mortgages make up a significant portion of the assets of almost all Australian ADIs, competitive distortions in this area could have a large effect on their relative competitiveness. This may include inducing smaller ADIs to focus on higher-risk borrowers. Restricting the relative competitiveness of smaller ADIs will harm competition in the long run.
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> The Inquiry believes the incentive to improve risk management capacity can be maintained with a narrower difference between mortgage risk weights. In implementing this recommendation, APRA should preserve appropriate risk incentives and take into account differences in the broader frameworks for IRB and standardised ADIs.
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> This recommendation addresses appropriate competitive neutrality of the risk-weighting framework. Larger ADIs may have a number of other advantages, such as economies of scale, more sophisticated business models, and a greater ability to diversify assets and manage risk. These are part of the market process; the Inquiry is not suggesting these are a problem.
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> The Inquiry considered two options to narrow the difference between standardised and IRB mortgage risk weights:
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> 1. **Recommended:** Raise average IRB mortgage risk weights.
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> 2. Lower standardised mortgage risk weights. In submissions, some ADIs argue that a mortgage risk weight of around 20 per cent would be appropriate.

World Council supports the Financial System Inquiry's recommendation to raise average IRB mortgage risk weights and believes that the Committee should in general increase the IRB risk-weights of all items subject to the IRB (or eliminate the IRB options), as the Committee has proposed in this consultation.

World Council also supports the statement in section 2.1 of the proposal that "jurisdictions will be considered compliant with the Basel framework if they do not implement any of the internally modelled approaches (ie they allow use of the standardised approaches only)."

We urge the Committee to finalize this statement as proposed. We believe that a jurisdiction that eliminates the IRB approaches as an option completely would have more stable, better capitalized banks that would be less likely to fail or require state assistance in a crisis.

If the Committee believes that standardised approaches do not have sufficient granularity for a particular large institution, these concerns can be addressed by making the bank in question subject to a high leverage ratio requirement in excess of its risk-based capital requirements.

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High leverage ratio requirements would ensure capital sufficient for a large bank to absorb losses as a going concern without state assistance while also making granularity concerns irrelevant.

Elimination of the IRB options in all jurisdictions would also be in the public interest. Complete elimination of IRB options would further increase global financial stability and reduce the competitive advantages that the world's largest banks enjoy over smaller, more conservative, and generally better capitalized financial institutions like credit unions and other mutuals.

World Council appreciates the opportunity to comment on the Basel Committee's consultative document on the *Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches*. If you have questions about our comments, please feel free to contact me at medwards@woccu.org or +1-202-508-6755.

Sincerely,

Michael S. Edwards
VP and General Counsel
World Council of Credit Unions