



March 11, 2016

Mr. Frank Pierschel and Mr. Ong Chong Tee
Co-Chairs, Task Force on the Standardized Approach
Basel Committee on Banking Supervision
Centralbahnplatz 2, Basel
Switzerland

Re: Comments on the second consultative document on revisions to the standardized approach for credit risk

Dear Messrs. Pierschel and Ong:

The Institute of International Finance ("IIF"), the Global Financial Markets Association ("GFMA"), the International Swaps and Derivatives Association ("ISDA") and the International Association of Credit Portfolio Managers ("IACPM") (and together, the "Associations") appreciate the opportunity to comment on the Basel Committee on Banking Supervision's ("BCBS" or the "Committee") second proposal on revisions to the standardized approach for credit risk (the "consultative document" or more generally, the "SA")¹. The Associations would also like to thank the BCBS Task Force on the Standardized Approach ("TFSA") for the opportunity to raise with them in person some of the industry's comments on the proposals at the meeting in Basel on February 17.

The industry understands the challenging nature of the work in revising the credit risk SA, especially since the new SA framework is intended to be applicable across all types of banks. As such, we are grateful for the iterative process being undertaken to ensure the ultimate approach balances the objectives of the Committee with the practical considerations of implementing fundamental changes to a core element of the Basel framework which will ultimately interact with the other components of the regulatory capital regime.

In particular, the Associations recognize and thank the Committee for considering the views of respondents to the first consultative proposal by acknowledging the limitations of removing all

¹ Basel Committee on Banking Supervision: *Revisions to the Standardised Approach for credit risk - second consultative document*, December 2015

references to external ratings and reintroducing them as part of the risk determination for certain exposures. We believe the Committee's objectives in balancing simplicity and risk sensitivity, promoting comparability by reducing variability in risk-weighted assets across banks and jurisdictions, and ensuring that the SA constitutes a suitable complement to the Internal Ratings-Based ("IRB") approach are better achieved by making available the use of external ratings rather than relying solely on the originally envisioned "risk driver" methodology.

Taking into account this valuable and considered work of the Committee, we believe, however, that aspects of the overall proposal would benefit from further review and amendment to ensure the mitigation of potential unintended consequences for downstream lending activity. Specifically, the industry believes that a few key themes should be carefully examined as discussions progress on the final framework, alongside the more punctual issues raised in our comment letter. These themes include the need to ensure comparability in relation to the application of risk weights across jurisdictions, the need to allay any potential of the proposals to unduly raise capital requirements on certain business lines and across bank portfolios and, in particular, the necessity to fully link the interaction of the SA with any ultimate proposal on implementation of capital floors and changes to the IRB approach. This would also need to be complemented by carefully assessing the holistic interaction between the SA revisions and other in-process Basel regulatory changes. We would also encourage the Committee to ensure that any calibration of risk weights and other factors (*inter alia*, credit conversion factors) is carried out in a manner that appropriately considers the underlying risk of the relevant exposures. In this regard, the industry supports the ongoing Basel monitoring exercise which includes a Quantitative Impact Study ("QIS") on the credit risk SA.

To achieve these objectives however, suitable timeframes for the development of the revised approach and associated QIS exercises need to be set for ongoing review and for complete consideration of all exposure types. Given that many of the proposed reforms, and our comments on them in this submission, will need to be balanced to reflect the aggregate data of the QIS on overall impact - along with insight into the formal thinking on a capital floors calibration and the finalization of other Basel standards - we believe that further consultation with the industry on the SA post QIS and post publication of proposals on floors will be vital, as the views put forward now will ultimately be enhanced by both the data of the impact analysis and a better understanding of the ultimate methodology of IRB approach interaction with the credit risk assessment of the SA. This will lead to further beneficial dialogue which we believe can aid the Committee in finalizing its proposals more efficiently and effectively.

As always, we very much appreciate our ongoing interaction with the Committee and the TFSA and we look forward to discussing and exploring the points in this letter. Should you have questions on our comments, please contact the undersigned or Matthew L. Ekberg at the IIF (mekberg@iif.com).

Very truly yours,



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COMMENTS ON THE PROPOSED REVISIONS TO THE STANDARDIZED APPROACH FOR CREDIT RISK

1. General Comments

a. Suggestions on the approach for review of the SA

The Associations believe the Committee should continue to reflect on key areas of the approach taken in revising the credit risk SA. We are grateful for the iterative process of stakeholder consultation thus far and encourage that process to continue through close consideration of the following issues:

i. A holistic review of the coherence of credit risk regulatory reforms

There continue to be several in-process regulatory changes coming not only from the Basel Committee, but also from regional and national regulators. These include, but are not limited to, decisions on the final calibration of the leverage ratio for global systemically important banks ("G-SIB"), the implementation of Total Loss Absorbing Capacity ("TLAC") standards to resolve a failing financial institution, sovereign risk proposals, operational risk proposals, the calibration of securitization by identifying "simple, transparent, and comparable" securitizations, interest rate risk in the banking book finalization, potential proposals on limitations on the IRB approach, and implementation of parallel standards on the Fundamental Review of the Trading Book ("FRTB"). In this regard, the industry finds it particularly difficult to comment fully on the proposed SA approach, and especially on the Risk Weighted Asset ("RWA") levels of the SA consultation, without any precise view of the future relationship between RWA under the SA and the IRB and the relationship of the SA in the final context of other reform proposals.

The SA revisions can have a significant impact on these other efforts to amend the Basel framework. The inherent difficulty in developing a new credit risk SA is that there are so many moving parts to its calibration. For example, changes to credit conversion factors ("CCF") influence the leverage ratio, the large exposures framework, and the scoring for G-SIBs. Within the Net Stable Funding Ratio ("NSFR") framework, required stable funding ("RSF") factors need to be assigned by using risk weights under the credit risk standardized approach. If these standards within the NSFR framework remain the same while risk weights under the credit risk standardized approach go up, then NSFR will be changed only due to revisions agreed under the SA.

Yet another example of the interconnected nature of the rulemakings is securitizations. The Basel Committee finalized the revisions to securitizations in December 2014. The Standardized Approach to calculating RWAs for securitizations references the Risk Weight ("RW") of the collateral pool on the standardized credit risk framework. Therefore, the changes in the current proposal on the SA for credit risk will impact on securitization RWAs, which may require a

change in the calibration to “Simple, Transparent, and Comparable” securitizations, and will then also impact on the “Standardized Measurement Approach” to securitizations in the FRTB.

In this regard, we appreciate the inclusion in the consultative document of the statement that the “Committee will evaluate appropriate implementation arrangements, including transitional or grandfathering provisions where necessary, and will provide sufficient time for implementation taking into account the range of other reforms that have been, or are due to be, agreed by the Committee.” Indeed, it is important for the Basel Committee to take into account the implementation timeline and the processes that each jurisdiction has to go through to transpose international standards to local rules.

However, as a single change in one rulemaking has knock-on implications and ripple effects throughout the regulatory capital framework, it is vital for all factors to be considered as the Committee continues its work. As such, a holistic assessment of these interactions needs to be undertaken with the industry before reforms are finalized to ensure that a revision in one rule does not inadvertently have adverse impacts on other areas and in order to determine whether the Committee has been successful in its goal of maintaining existing capital levels in the system.

ii. Interaction of the SA with the IRB Approach

The need for a holistic review of the Basel agenda is particularly true when considering the interaction of credit portfolio risk between the SA and the introduction of capital floors to the IRB approach, along with revisions to the IRB approach more generally. As such, the nature of our comments to the SA consultative proposal may evolve following the future release of details on the level and structure of capital floors and any proposed revisions to the IRB approach. In the absence of clarity on the expected granularity and calibration of possible floors, the risk sensitivity of RWA under the SA should be a major objective of the reform, which does not seem to be the consistent focus in the current consultation. This is an issue we explore throughout this submission. We believe improvements to risk sensitivity can be achieved without introducing undue complexity to the framework or compromising the comparability between banks.

The Associations continue to have serious and material concerns on setting capital floors, either at the aggregate, risk category or exposure class level for IRB banks. In this regard, the final impact of some proposals in the consultative document should be considered for their effect on a bank that solely uses the standardized approach for the determination of its credit risk capital requirements and a bank that may face capital requirements from the SA as a floor to its IRB-based RWA. We continue to believe that a potentially overly simplistic standard such as a floor may in the end reduce risk sensitivity overall and that targeted solutions should be explored to preserve the many benefits of internal models while addressing undesired shortcomings.²

² For further information on capital floors and risk sensitivity in the capital framework, please see:

A capital floor calculation based on the SA is dependent on the interpretation and availability of granular measures needed for the SA computation, which might differ by regions and supervisory practices. This could, once again, lead to undue variance in RWA. Though we recognize there are indeed limitations to the IRB approach which will need to be addressed through forthcoming dialogue, we are still fully convinced that the standardized approach can be only complementary to the IRB models, which remain the best option in terms of risk sensitivity for banks for which their use is approved. We understand the scope of this consultation is limited to the SA; however, revisions to the SA and implementation of capital floors cannot be separated in terms of impact. We encourage the TFSA, the Coherence Taskforce and the full Basel Committee to work together and with the industry as these issues are finalized.

iii. Analysis of pending QIS data

The Associations welcome the ongoing Basel III monitoring exercise that includes a QIS on the credit risk SA. We believe, however, there is a material timing mismatch on the gathering and analysis of the QIS data and the submission period for comments on the consultative document. Empirical data on the credit risk revisions will greatly inform both industry and Committee thinking on the proposals and should be discussed with the industry in the context of our comments herein, which we submit may evolve based on the outcomes of the data gathering exercise.

We respectfully encourage the Committee to formally engage with the industry on the risk sensitivity in the SA again once the full results of the current QIS can be analyzed. Though we fully understand the Committee's timeline on finalizing the SA this year, we strongly believe that this dialogue will serve to help the Committee in formalizing its proposals in the most effective manner.

b. The use of external credit ratings and comparability considerations

The reintroduction of external ratings to the SA proposals is an important recognition of the need to balance simplicity with granularity in the Committee's objective review of the framework. We discuss this balance in greater detail later in this submission, but highlight here the comments by the Committee on the aim to reduce the mechanistic reliance on ratings and enhance the role of due diligence processes.

We agree that an additional level of analysis to complement the ratings set by external agencies benefits the overall risk management efforts of financial institutions. Indeed, we have made the point that large internationally-active banks generally are using internal risk

Institute of International Finance, *Risk and Capital: The Essential Nexus*, September 2015: <https://www.iif.com/publication/regulatory-report/risk-and-capital-essential-nexus> and Institute of International Finance, Letter to Mr. Mario Draghi and Mr. Stefan Ingves, November 20, 2015: <https://www.iif.com/publication/regulatory-comment-letter/iif-risk-weighted-assets-letter-basel-committee-banking>

measurement tools and models complemented by thorough credit risk approval processes involving credit risk committees and further testing requirements.

However, the Committee notes in the revised consultative proposal that adding due diligence requirements may impair the comparability of capital requirements. As part of this discussion, the Committee is considering whether to further enhance disclosure requirements and, in particular, states that the Financial Stability Board (“FSB”) Principles recommended that, in order to provide market discipline, banks should publicly disclose information about their credit assessment approach. While we understand the Committee’s intentions in this regard, we believe it is important to note that careful consideration should be given on whether this further enhancement to disclosure requirements is really necessary as a means to rectify any perceived impairment in the comparability of capital requirements that may follow. We emphasize that there are differences between the methods used for credit assessments in approval processes and calculation of capital requirements. It is not the case that banks rely solely on external ratings for credit assessments if they use them for capital calculations. To begin with, the BCBS principles for the management of credit risk³ (which in many countries have been implemented through national rules and guidance) require banks to have sound credit assessment processes, effectively akin to internal ratings, even if these methodologies do not fulfill all of the requirements for an IRB approach. Therefore, the capital calculation may rely on external ratings for the purposes of assigning risk weights; however, the credit assessment process does not. This is also evidenced in the practical application by banks of revised Pillar 3 disclosure requirements⁴ and monitoring requirements for credit risk under the guidance on credit risk and expected credit losses issued in December 2015.⁵

Lastly, the discussion of jurisdictional specificities regarding the use of external credit rating assessments, alongside the application of due diligence standards, must be carefully considered by the Committee. Namely, the industry believes it is of paramount importance that in reform of the SA framework, an adequate level of comparability between all jurisdictions is maintained. We believe that there are current imbalances in the consultative proposal on the use of external ratings between jurisdictions which is likely to be problematic, especially for international customers engaging in simultaneous banking relationships with internationally active banks. Risk weightings should be the same for a given level of underlying credit risk across jurisdictions. Consideration should be given to adjusting RWA levels to factor in possible national specificities while maintaining an acceptable level of capital in the financial system.

³ Basel Committee on Banking Supervision; *Principles for the Management of Credit Risk*, September 2000

⁴ Basel Committee on Banking Supervision; *Revised Pillar 3 disclosure requirements*, January 2015

⁵ Basel Committee on Banking Supervision; *Guidance on credit risk and accounting for expected credit losses*, December 2015

c. Assessment of impact and increasing capital requirements

Through the revised consultative proposal, the Committee once again states that increasing overall capital requirements under the SA for credit risk is not an objective and, instead, capital requirements should be commensurate with underlying risk. A similar iteration of the objectives of revisions to additional Basel standards underway has also been presented in other fora, however, the Committee has acknowledged, for example, that they expect a 40% increase in trading book RWAs from the FRTB and the Associations see the very real likelihood that capital requirements will also increase under the new SA proposals to the detriment of critical bank lending activities. This we believe will be particularly true when it comes to the Committee's proposals on credit conversion factors for off-balance sheet instruments.

Completed quantitative impact studies have made clear that the industry is facing additional substantial changes to the regulatory capital framework that will result in significantly higher RWAs, with potentially deleterious impacts on banking services supporting the broader economy. We strongly believe that this increase should be mitigated to avoid consequential negative changes in the nature of banking services for businesses and individuals globally.

2. Bank Exposures

The Associations are grateful that the recognition of the limitations of the risk driver approach originally envisioned by the Committee has led to a number of positive changes in the scope of the proposals outlined, including, as noted, the reintroduction of the use of external credit ratings. Though we understand the Committee's objective in attempting to reduce the mechanistic reliance on ratings, (and, indeed, as part of our comments on the first consultation we suggested a balanced approach between external ratings and a more granular analysis of risk) we believe there are several outstanding issues to be addressed relative to the methodology proposed by the BCBS in the current consultation.

a. External Credit Risk Assessment Approach ("ECRA")

For rated exposures of banks incorporated in jurisdictions that allow the use of external ratings for regulatory purposes, we understand a bank would determine the "base" risk weight of an exposure based on the external rating of the counterparty/exposure using a look-up table. The consultative document proposes that a bank would perform due diligence to ensure that the external rating appropriately and conservatively reflects the credit risk of the exposure. If the due diligence assessment reflects higher risk characteristics than that implied by the external rating of the exposure, the bank would apply a higher risk weight for the exposure.

The Associations believe that the amount of variability in "due diligence" under the ECRA could lead to unintended consequences and divergence in application of RWAs across banks and jurisdictions. Moreover, due diligence could achieve the opposite result in terms of comparability if guidelines around criteria are not carefully considered. As such, the level of

prescription for enhanced due diligence standards applied in addition to external ratings must be correctly calibrated, particularly as the quality of external credit ratings have been much improved in the last several years.

We therefore emphasize that due diligence envisioned by the Committee should not encompass entirely new processes which would prove very difficult to implement, especially if a goal of the revised framework is the enhancement of simplicity and comparability. The Associations believe that as a starting point, the Committee should recognize the strong credit management practices already in place for banks subject to the IRB approach. Instead of creating another layer of due diligence management under the SA, the Committee should allow banks to supplement their use of external credit ratings where applicable with the due diligence standards already being utilized by banks approved to use the IRB approach. This will avoid duplicative and variable analysis and will still fulfill the mandate of reducing a mechanistic reliance on ratings.

For banks not subject to the IRB approach, we note again that BCBS principles for the management of credit risk require banks to have sound credit assessment processes, effectively akin to internal ratings, even if these methodologies do not fulfill all of the requirements for an IRB approach. These processes, we believe, constitute a better way of creating an additional layer of risk assessment than creating new standards for banks of all sizes. In particular, small and medium sized banks may not have the means to add an additional, complicated and unclear layer of due diligence to their already built in processes and thus should be able to rely on standards already in place that are considered both efficient and effective by the Committee and national supervisors.

The industry also notes that banks will now uniformly be expected to act under BCBS Guidance on credit risk and expected credit losses issued in December 2015.⁶ While the main objective of the Guidance is to promote high-quality, robust and consistent implementation of expected credit loss (“ECL”) accounting; due to the strong linkage of ECL accounting to credit risk management, the Guidance contains detailed information about credit risk management practices (Principle 2) and credit rating process (Principle 3) as well as specific examples related to retail and wholesale portfolios (International Financial Reporting Standard (“IFRS”) Appendix). In this Guidance, the BCBS heightened supervisory expectations for internationally active banks and also acknowledged that depending on the size, complexity, structure, economic significance and risk profile, banks could adopt properly designed proportionate approaches.

These additional layers of credit analysis already in place provide a strong basis for enhancing due diligence in addition to the review of external credit ratings. We strongly encourage the Committee to utilize current guidelines in a uniform manner rather than creating new and potentially inconsistent standards.

⁶ Basel Committee on Banking Supervision; *Guidance on credit risk and accounting for expected credit losses*, December 2015

Lastly, we are concerned with a certain lack of sufficient differentiation in risk weights under the ECRA for banks. We believe that there should be a distinction in the base risk weights between A and BBB rated banks. Currently the risk weights for both buckets are 50% and we recommend changing the risk weight for banks rated A to 30% to reflect the lower risk of more highly rated investment grade banks. Among G-SIBs, only a few banks are rated AA and over, where a 20% risk weight is applied. Other G-SIBs are rated A and under. Thus, a 50% risk weight seems unduly conservative and should be revised appropriately.

b. Exclusion of government support for external ratings

The Associations believe that the proposed exclusion of government support from banks' external ratings as used for regulatory capital purposes could be problematic from a practical perspective. Though rating agencies are aware of this issue in the context of other regulatory reform measures (including those pertaining to recovery and resolution) and are in some cases removing government support from their ratings for many banks, we believe that this point should be addressed primarily by the rating agencies in consultation with the appropriate authorities, as financial institutions need to be able to rely on ratings published by the agencies as they stand at the time of application of the SA framework. It will also be very difficult to implement such a proposal given that data is only partially available and the treatment of government support by the rating agencies is not homogeneous. Additionally, in some cases, banks are partially government-owned and it is not clear whether this state-owned equity shareholding (or even potential full ownership) would be considered to fall under 'implicit government support' for the purposes of the proposal.

While the industry stands ready to work with the Committee on implementing this area of the consultation, we suggest this issue be clarified at this stage to allow for flexibility in use of government support in external ratings where other options are not available or where the institutions are either partially or fully state-owned. Lastly, we understand and appreciate that removing government support is a very clear policy objective of the Committee and a great deal has already in fact been done to achieve this outcome. Adding another layer of complexity to the SA to deal with an issue that we expect will be resolved in the near future would seem to stand in contrast to the objectives of the consultation on increasing simplicity in the framework.

c. Standardized Credit Risk Assessment Approach ("SCRA")

Under the consultative proposal, for unrated exposures of banks incorporated in jurisdictions that allow the use of external ratings for regulatory purposes (and for all exposures of banks incorporated in jurisdictions that do not allow the use of external ratings for regulatory purposes) the Committee proposes that a bank should as part of its due diligence assessment be able to assess the credit risk of an exposure and classify the exposure under grading system A to C with the commensurate risk weighting applied.

The industry believes that the general criteria and triggers applied under SCRA for Grades A to C are largely imprecise, not necessarily aligned with bank business models (in particular, the criteria for repayments of principal and interest would appear more applicable to corporate debtors) and it will likely be unduly burdensome to document the due diligence undertaken and the results that lead to the assignment of the appropriate grade. In general, this method appears to be very onerous for countries with large populations of unrated savings and cooperative banks. Under Basel II, these countries generally chose the option to base the RW on the risk weight of the sovereign. In the European Union (“EU”), unrated banks still receive a risk weight which is based on the risk of the sovereign rather than requiring a more elaborate assessment. The Associations believe this could be a more appropriate solution for a standardized approach which should be simple to use.

As an alternative, and to make this method of due diligence more effective, the Associations suggest examining the grading approach and aligning it more closely with the approach taken under the ECRA. We propose enhancing the granularity of the system by adding additional risk weighting options where appropriate. Specifically, the associations believe that an additional bucket should be introduced (making the grading A-D) with the commensurate risk weight under each grade being 20%, 50%, 100% and 150% respectively. The criteria for the determination in applying the appropriate risk weight for exposures classified under each bucket should be linked closely to the principles applied by the leading rating agencies to exposures rated in the look-up table under the ECRA approach. We believe this would provide comparability between the ECRA and SCRA, assist in limiting jurisdictional variability concerns, and increase the granularity of the SCRA without sacrificing simplicity.

d. Risk weight floor for bank exposures

Where external ratings are not available or used, the Committee is of the view that this may be reflected by incorporating country ratings (e.g. Organization for Economic Cooperation and Development (“OECD”) country ratings) as an objective criterion for each grade bucket under the SCRA, or by imposing a risk weight floor based on the risk weight applied to the sovereign exposures (as a proxy).

In some cases the industry shares the view that due diligence should consider country risk, mainly by assessing the counterparty’s capacity to meet financial commitments under adverse economic cycles. However, we believe that country risk should not be taken into account when the exposure is not subject to convertibility and transfer risk. The capital requirement for these exposures should be equivalent to that of similar exposures subject to convertibility and transfer risks and guaranteed by a Multilateral Development Bank (“MDB”). In the same vein, we also believe that the ECRA should be based on National Scale Ratings, when available, for exposures that are not subject to convertibility and transfer risks. Alternatively, in order to compensate the economic volatility of non-investment-grade countries, the Committee could consider introducing a “grade AA” category for counterparties that exceed

120% of minimum regulatory requirements and buffers established, not subject to a country risk floor.

Under the current proposals, the floor would also likely only apply in case the country is sub-Investment Grade. In practice, it would flatten risk weights to 100% and make the grading unnecessary, apart from the identification of stressed counterparties. From this perspective, in case a country-specific risk floor is considered, it could be considered to have the grading under SCRA limited to investment grade countries.

e. Short-Term interbank exposures

The industry supports the Committee's proposal to maintain a preferential risk weight for short-term interbank exposures, as this will likely lead, if defined correctly, to improved market liquidity in interbank markets. We continue to believe, however, that this preferential treatment should be applied to exposures to an institution in relation to *residual* maturity in order to appropriately reflect the underlying risk at any moment. This could otherwise actually imply a negative impact on market liquidity in interbank markets and could also lead to higher capital requirements in this area depending on the bank portfolio.

We also believe that the definition of "short-term" as 3 months is too limited and is misaligned with other prudential rulemakings, primarily the NSFR. Depending on the asset, the duration of firm funding must be at least 6 months to get partial credit under the NSFR and must be at least 1 year to get full credit. In response to the NSFR, banks have been working to extend the duration of firm funding. However, the action that banks have taken in response to the NSFR is misaligned with the proposed SA framework. Banks must choose to either receive credit under the NSFR and be subject to higher RWAs; or choose lower RWAs and be penalized in the NSFR. We therefore urge the Basel Committee to extend the definition of short-term up to one year in order to better align it not only with the NSFR but also with accounting principles, TLAC, and other pertinent regulatory standards.

f. Exposures to securities firms and other financial institutions

We appreciate the Committee's review of exposures to securities firms and other financial institutions and welcome the recommendation to treat these as exposures to banks, subject to certain standards. We note, however, that under Paragraph 30 of the consultation, the Committee refers to the 'risk drivers used to ascertain the applicable risk weights (or the information to calculate them)'. This reference would appear to relate to the 2014 consultation prior to the removal of risk drivers from the perspective of the application of the SA and we respectfully request the wording in this section be updated to align the treatment of these exposures with the updated treatment of bank exposures.

In addition, we believe that the liquidity requirement included as one of the prudential standards applied when determining the treatment for exposures to securities firms and other financial institutions should be revisited. Given that liquidity requirements were introduced by

Basel III, securities firms and other financial institutions located in jurisdictions that have not implemented Basel III would not be able to comply with this requirement. Therefore, in order to ensure jurisdictional variability is mitigated, we suggest removing the liquidity requirement as a prudential standard required to achieve treatment as a bank exposure in this area.

The level of supervision for these entities should, in our view, also be carefully considered and judged at a group level consolidated basis rather than at the unconsolidated entity level, since some securities firms disclose their regulatory ratios on a group basis without any data disclosure for each individual firm within the group. If the level of supervision is judged for each firm when determining their ability to be treated as a bank exposure, then issues may arise whereby a group holding company is treated as a bank exposure and individual group companies may be incorrectly treated as corporate exposures.

3. Corporate Exposures

The Associations are again grateful that the Committee has reintroduced the use of external ratings for determining the credit risk of some corporate exposures. We would, however, request careful review of several issues in the consultative document in this lending area. In particular, we are concerned that the revised proposals still do not provide a risk sensitive outcome for certain borrowing segments. For example, in conjunction with Global Credit Data ("GCD")⁷, we have conducted a quantitative survey⁸ in which banks were asked to provide estimates of the percentage of their existing corporate and small and medium-sized enterprise ("SME") portfolio which are externally rated.⁹ The results show that a majority of the large corporates exposures and nearly all exposures to SMEs are not externally rated. Although, this is particularly apparent for the non-investment grade corporate exposures (rating of BB+ and below) where only 2.5% of these exposures are rated, only a small proportion (18.5%) of the investment grade corporate exposures (rating of AAA to BBB-) are also rated. As such, a flat 100% risk-weighting would apply in these circumstances (with 85% to SME exposures) and would result in unwarranted higher RWAs for high quality corporate exposures.¹⁰

In addition, we disagree that applying the hierarchy of approaches designed under the bank exposure framework (*i.e.*, ECRA and SCRA) would not be possible for this exposure class. We believe banks do have the ability to identify objective criteria to classify corporate counterparties into credit risk grades. Greater comparability in how bank and corporate

⁷ Global Credit Data (GCD) is a not-for-profit initiative to help banks to measure their credit risk. The consortium is owned by its 48 member banks across Europe, North America, Africa, Asia and Australia. It is the world's largest banking book EAD/LGD database with over 100,000 defaulted facility observations totalling over €200 billion in all Basel asset classes. It is also the world's largest database of defaults and PD estimates for Large Corporates, SMEs, Banks and FIs, and Specialised Lending.

⁸ 17 of the IIF member banks participated in the GCD quantitative survey with banks based in Europe (8 banks), Asia Pacific (5 banks), North America (2 banks) and other regions (2 banks).

⁹ If counterparty is not externally rated, the equivalent external rating was estimated by banks based on their own internal risk assessment processes.

¹⁰ A detailed breakdown of this analysis can be found in Appendix 1.

exposures are examined for application of RWAs will be beneficial to ensure consistency across banks and jurisdictions in their credit risk review processes and will assist in enhancing risk sensitivity in the framework. However, many of our concerns outlined for due diligence requirements and the granularity in the application of RWs applied to bank exposures also apply in commentary around the re-proposal of the treatment of corporate exposures.

a. Due diligence requirements

For rated corporate exposures, the application of due diligence standards as defined by the consultation should take into account the credit review processes currently being applied under the standards of the IRB approach, the BCBS principles for the management of credit risk, and the BCBS guidance on credit risk and expected credit losses, as noted in our comments under the ECRA section above for bank exposure due diligence. Creating an additional layer of risk assessment will be duplicative and will lead to variability in its application due to the lack of specific guidance present in the current consultative document.

b. Risk weight determinations

The Associations have material questions and concerns in relation to the proposed risk weighting of certain corporate counterparties as proposed for *both* rated and unrated exposures. For example, as part of the GCD quantitative survey noted above, a comparison of the risk-weighting under the SA and IRB approach¹¹ of corporate exposures per each external rating grade was conducted.¹² The results of the survey demonstrate that RWAs for the same exposure under the SA are significantly higher for highly rated exposures and somewhat lower for lower rated exposures, when compared to the RWAs under the IRB approach.¹³ As such, we would urge the BCBS to consider the calibration of the risk-weightings in order for the SA to achieve a more risk sensitive outcome.

In considering this issue, it would also be appropriate to have greater transparency around the BCBS analysis performed to support the unexpected loss distribution and associated credit parameters in each of the segments that apply the proposed risk weights. Such transparency would facilitate greater engagement with the industry in the development of the revised approach. Without review and discussion on the RWAs applied in this area, we believe there is material concern for a significant lack of comparability in their application across banks and across regions as well as the potential to increase capital requirements.¹⁴

¹¹ RWA results under the IRB approach are conservative risk estimates by GCD based on historical data.

¹² Notwithstanding that variances in RWAs under the IRB approach exist, and that the BCBS intends to review the IRB approach in 2016, the Associations are of the view that the IRB approach is a logical reference point for risk sensitivity in this regard.

¹³ The charts in Appendix 2 illustrate the RWA impact of the SA as a relative increase of the RWAs under the IRB approach.

¹⁴ Additionally, as RWs are amended under the SA framework, we believe a transition period should be put in place to allow banks to adapt lending activity to their application.

In particular, the industry believes consideration should be given to the RW of a rated BBB corporate exposure. The RW of BBB (*i.e.*, investment grade) corporate exposure is proposed as 100%, which is the same as BB (*i.e.*, non-investment grade). As BBB is likely to have better credit quality than BB, the RW for BBB corporate exposure should be revised to 50% commensurate with bank exposures in order to apply a more risk sensitive and comparable framework. For SME exposures, we strongly agree with the application of a reduced risk weight, however, we propose that given the nature of SME lending, the risk weighting applied should be lower than the proposed 85%. A more suitable scaling factor applied for IRB approach corporates, which reduces the risk weight for corporate SMEs, could be considered. Alternatively, alignment with the 75% risk weight assigned to SMEs in the regulatory retail exposure class would be appropriate in our view, particularly as there is likely to be more individual credit management for corporate SMEs. This would improve simplicity and reduce arbitrary differences for SME exposures.

We also believe the Committee should examine closely the granularity of the approach taken to rated corporate exposures overall. We believe the number of classifications may not be sufficient in terms of risk sensitivity for this type of lending and could be subdivided subject to external ratings like a securitization exposure. The risk weights are also still higher than those under IRB approach and in terms of comparability between IRB and SA approach, it is preferable that the risk weights under those two approaches are similar. Alternatively, the Committee could consider examining use of the six grades used by European Banking Authority (“EBA”) in its mapping of external credit agencies¹⁵ or the grades already proposed by the BCBS for Pillar 3 reporting.¹⁶

Additionally, we believe a flat risk weight of 100% for unrated corporates is particularly punitive for unrated but low default counterparties such as managed funds (and sovereign wealth funds, as discussed in more detail below). This risk weight will also likely in practice be applied to medium-sized corporates and we recommend that the ultimate risk weight calibration of this category should not result in an inconsistent capital treatment that may unintentionally reduce the supply of credit to this sector. We believe that an approach more akin to that of the SCRA approach for bank exposures (with the additional granularity of buckets applied as noted in that section of our response) would be more appropriate and risk sensitive.

The same granularity concerns apply for corporate exposures in jurisdictions that do not allow the use of external ratings for regulatory purposes. We believe every jurisdiction should apply the same approach to risk weighting of unrated corporate counterparties, similar to bank exposures. Hence if an investment grade classification based on internal assessments is

¹⁵ European Banking Authority; *Joint Final Draft ITS on the Mapping Of ECAIS' Credit Assessments under Article 136(1) and (3) of Regulation (EU) No 575/2013 (Capital Requirements Regulation - CRR) - JC 2015 067*, 11 November 2015

¹⁶ Basel Committee on Banking Supervision; *Revised Pillar 3 disclosure requirements*, January 2015

allowed in jurisdictions that do not allow the use of external ratings, this approach should also be allowed in jurisdictions that allow external ratings.

These jurisdictions effectively apply two classifications; investment grade and non-investment grade. We believe it is also appropriate to add another investment grade classification with a RW of 50% based on internal assessments. This will better align the treatment of exposures in this category with those that allow the use of external ratings. This additional level of classification is also critical to incentivize appropriate credit risk mitigation and to potentially reduce undesired interconnectivity. Under the consultative proposal, should a bank unable to use external ratings wish to purchase credit protection, the best answer from a RW perspective is to purchase protection from a bank. Given the leverage ratio requirements to gross up for full notional value on sold credit protection, it has become much more difficult for banks to purchase credit protection from other banks. By adding additional specificity to the corporate RW classifications, banks will be able to better manage their credit risk by being able to purchase credit protection from beyond the banking sector, which has the added macro prudential benefit of reducing interconnectedness in the system.¹⁷

c. Ratings of parents and subsidiaries

We request clarification on paragraph 100 of the consultative document which states that the external ratings for one entity within a corporate group cannot be used to risk weight other entities within the same group. The Associations believe the interpretation of this clause would allow for more risk sensitivity in the framework if there is allowance for some level of transfer of ratings from parents to subsidiaries and that where a parent/subsidiary relationship exists, then the subsidiary may be notched down depending on the ownership structure and degree of control over the subsidiary.

d. Other issues

We request additional guidance on the RW treatment of sovereign wealth funds ("SWF") in the context of this area of review. We particularly believe that the flat 100% RW applicable to unrated exposures for SWFs is especially punitive and requires revision. While we understand that there is a parallel work stream on sovereign risk currently underway, we believe the current treatment of sovereign wealth funds as corporate exposures is overly burdensome for the nature of these entities. The obligations of SWFs are generally not explicitly supported or guaranteed by their respective sovereigns, however, they enjoy a high level of implicit support, generally serve a public policy function, and typically receive all of their funding from their

¹⁷ We also note that the 'investment grade' conditions under paragraph 173 require corporate entities to have securities outstanding on a recognized securities exchange. We question if this criteria is relevant for determining the creditworthiness of corporates since there is a significant population of corporates that will fail this criteria but should nonetheless be considered as creditworthy. Further, the share of corporates having securities outstanding on a recognized securities exchange differs significantly between jurisdictions. To mitigate this issue, the Committee should either consider allowing national regulators to define additional criteria that fit better to the local environment or define broader criteria, such as having audited financial statements included.

sovereign and should qualify for a preferential risk weight, albeit floored at the RW of the sovereign.

4. Specialized Lending Exposures to Corporates

The Associations welcome the Committee's recognition of the need for specialized lending ("SL") exposures to be subject to regulatory capital treatment distinct from other exposure classes, as well as the need for a more risk-sensitive, granular approach for these exposures compared to the existing SA.

This being said, we believe the current proposals do not appropriately reflect the underlying risk levels of these exposures and are based on the misconception that specialized lending exposures exhibit higher risk and higher losses than other types of corporate exposures, including unsecured corporate exposures. This is entirely inconsistent with industry experience and data, as described below. We would therefore welcome disclosure of the data on which the BCBS has based its conclusions in order to analyse and discuss this further with the Committee.

Moreover, contrary to what appears to be assumed in the consultative document, issue specific ratings are generally almost non-existent for specialized lending exposures. Therefore, the flat risk weights proposed by the Committee, which are particularly punitive, will become the default approach to risk weighting specialized lending exposures. The introduction of undifferentiated risk weights (which are not commensurate with the underlying risk of the exposures in question) presents, in our view, a missed opportunity for improvements in the standardized approach. We therefore suggest a number of proposed amendments that will enhance risk sensitivity without impacting simplicity and comparability.

a. Specialized lending performance

On average, specialized lending has exhibited low risk levels. This is due to the bespoke, structured and collateralised nature of these products. For example, for project and object finance, structures are put in place so that the lender controls the cash flows generated from the underlying asset(s) and/or benefits from the security of the asset itself. On average this leads to low loss rates. Moreover, banks benefit from diversification across their specialized lending portfolios, where the values of different infrastructure assets, aircraft, vessels, rolling stock and various commodities are not correlated.

Given its bespoke, specialized nature, the SL business can also be described as "risk sensitive". In other words, it is by definition a non-standardized business, not suited to flat risk weights. While losses are on average low, they can vary depending on the level of conservatism, structuring and protection built into the deal. Banks can structure loans with conservative terms and Loan-to-Value ("LTV") ratios, taking into account the position in the cycle, and tight collateral structures. If they wish to be more aggressive, they might include higher LTVs and looser structures in their deals, potentially leading to higher losses in cases of default. Under IRB models, this would be reflected in the banks' Loss Given Default ("LGD") levels. Under the

SA however, it is challenging to devise a simple, standard method that is sufficiently risk sensitive and recognises the value of the different types of underlying collateral. Flat risk weights or risk weights that depend on only one or two risk drivers are simply not appropriate for this business type.

Consequently, the SA treatment of specialized lending cannot be dissociated from ongoing discussion on capital floors and the future IRB treatment of these exposures. In all markets, emerging and developed, and especially where there is high demand for large infrastructure, asset or raw materials financing, the steep increases in specialized lending risk weights proposed under the revised SA would be highly penalising, with potentially higher economic impacts in jurisdictions where capital markets are not sufficiently deep and alternatives to bank financing limited.

We wish to stress the negative consequences of using a standardized approach either as an alternative to internal modelling or as the basis for a capital floor for specialized lending exposures. If the same risk weights apply to transactions of very different risk levels, banks' decision making might become biased towards higher risk transactions which will have higher levels of return for the same amount of regulatory capital. In such a case, the quality of banks' portfolios would over time deteriorate and the activity may increasingly shift into the unregulated sector.

b. Recognising the value of the underlying collateral

In our view, there is a need for greater recognition of the underlying collateral in SL transactions. As they stand, the proposals do not seem to be consistent with the general principle that a collateralised exposure should not receive a higher risk weight than an otherwise equivalent unsecured exposure. This is visible for instance in the following examples:

- Lending to an operating power plant on an unsecured basis would get the same RW (100%) as lending with a typical Project Finance security package which enables lenders to restructure the loan if needed, benefiting from future, long-term cash flows, or to take control of the asset and sell it if needed. In this example, there is no recognition of the value of the project finance structure, the security package or the banks' control of cash flows and in-depth due diligence
- Under the proposals, a loan to an airline without security on an aircraft would receive a lower RW (100%) than a loan with an SL structure, *i.e.* with a first lien security on the aircraft (120% under the SA proposal). In this example, the value collateral (aircraft) appears to make a negative contribution to the risk weight.

c. Comparisons between the SA proposals and industry data

In theory, for a given borrower rating, an SL loan should have a lower risk weight than an unsecured corporate loan. A simple calculation based on data from GCD provides an

indication of typical, comparable risk weights for an SL transaction and an unsecured corporate exposure:

Borrower grade:	Corporate			IRB			SL	IRB SL
	PD	LGD	Maturity	RWA	SL PD	SL LGD	Maturity	RWA
BB+	0.75%	40%	3 years	83.8%	0.66%	25%	5 years	64.2%

While the maturity of the SL is higher, the LGD improvement more than offsets this difference in the resulting RW. According to GCD data, SL portfolios have median obligors between BBB and BB. Looking at a BB+ obligor as an example, the RWA level for SL would be 64.2% – significantly lower than the proposed risk weights of 100% and 150% for project finance under the SA proposals.

Industry loss data for SL¹⁸:

	ODF	LGD	Loss Rate
Aircraft finance	1,96%	16%	0,31%
Shipping finance	3,13%	13%	0,41%
Commodities finance	0,89%	13,3%	0,12%
Project finance	1,50%	23%	0,35%

Industry data show that historical loss rates are in the range of 0.12% – 0.35%, depending on the type of SL product. While technical issues such as downturn calibration would need to be taken into account, the table below offers an initial comparison of the SA proposal with RWs calculated on the basis of this historical data, revealing that RW levels between two to four times higher than actual default and loss experience suggest would be appropriate. While the difference would decrease with more directly comparable parameters, it would nevertheless remain significant.

	RW based on historical data	SA proposal	SA proposal/ RW with observed data , 5 years
Aircraft finance	55 %	120%	2x
Shipping finance	50 %	120%	2x
Commodities finance	33%	120%	4x
Project finance	75%	150% ; 100%	2x, 1,3x

¹⁸ Aircraft and shipping finance data is supplied by GCD, with a risk free discount rate and 5% added to the historical LGD rate as a proxy for downturn calibration; project finance data is supplied by S&P, where the discount rate is the loan rate; the commodities finance data is supplied by the AFME Discussion Paper 'Capital Treatment of Commodity Finance', December 2015.

*RW calculated with an assumption of an average life of 5 years for Project Finance & Object Finance and 1 year for Commodities Finance

d. Suggested alternatives to the current BCBS proposals

There is a need to distinguish between types of specialized lending products, where risk weights are more appropriately calibrated to take into account the specific product characteristics and industry loss experience. As such, we suggest the following:

- Project finance - recalibration of the proposed risk weights. As already noted above, long term default and recovery statistics show that performance for this lending category is better than that of unsecured corporate lending. The Annual Global Project Finance Default and Recovery Study by S&P Capital IQ from December 2015 reveals an average Probability of Default ("PD") of 1.5% and LGD of 23% over the last 15 years. Calibration of the SA risk weights applicable to this exposure class need to reflect these data and should be lower than unsecured corporate risk weights. Given the specialized, bespoke nature of this business, the BCBS may also wish to consider including a proxy for the level of expertise of the project finance team (for instance, the average years of experience of those involved) as a factor contributing to the final risk weight.
- Object finance - recognition of collateral through LTVs. This category of SL is substantially similar to commercial real estate, demonstrating sustainably low credit losses as per paragraph 49 of the proposals, with the same requirements/eligibility criteria as set out in paragraph 50 being fulfilled (in particular, the legal enforceability of creditors' claims is effective and the valuation of assets is generally appraised independently). As such, we recommend that the risk weights be based on the collateral securing the relevant exposures (and not the counterparty), preferably distinguishing between different collateral types (aircraft, rail and shipping finance) and referring to residual maturity and typical industry LTV buckets.
- Commodity finance - recalibration of the proposed risk weight. Industry data as reflected in a data collection exercise of commodity finance banks suggests that RW of 50% would be more appropriate.¹⁹

A slotting approach, similar to the alternative that exists today under the IRB could also be envisaged. This would help improve alignment between the SA and IRB approaches. We do note, however, that consistent implementation of the slotting approach is more of a challenge than the other approaches suggested above. It is useful to note also the findings of a recent EBA study on the use of the slotting approach by EU banks.²⁰ Some 23%, or 238 billion euros,

¹⁹ Association for Financial Markets in Europe (AFME); *Commodity Finance Discussion Paper: Capital Treatment of Commodity Finance*, December 2015

²⁰ European Banking Authority; *Consultation Paper on Draft Regulatory Technical Standards on Assigning Risk Weights to Specialized Lending Exposures under Article 153(9) of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR)*, 11 May 2015

of all slotting exposures under the IRB approaches fall under the slotting approach. Of these, 70% are classified as either category 1 or category 2 exposures where category 1 corresponds to either a 50% risk weight (for maturity below 2.5 years) or a 70% risk weight (for maturity equal to or above 2.5 years) and category 2 to a 70% or 90% risk weight (for maturities of below and above 2.5 years respectively). Again, this data provides a clear indication that the current SA proposals are overly conservative and should be better aligned with true underlying risk levels.

5. Subordinated Debt, Equity and Other Capital Instruments

The Committee states that for equity holdings that are not deducted, a 250% risk weight should apply. In our view, however, applying a 250% risk weight for equity is excessively conservative, particularly compared with a 100% (unrated) risk weight for corporate exposures and a 150% risk weight for subordinated debt.

We still consider that an add-on to the risk weight assigned to the senior exposure would be a sensible and risk sensitive approach (similar to the use of a 90% instead of 45% LGD under the FIRB) for equities. We believe that a flat risk weight set at the current proposed level is too punitive and does not truly reflect the actual risk. If more risk sensitivity can be achieved in a simple and comparable manner, this should be pursued. In this same vein, we would also propose consideration of applying simple and appropriate graduated risk weights to equity exposures with a calibration to be discussed with the industry. As an alternative, the Associations would consider a risk weight in the range of 200% appropriate for equities, (which is two times the proposed risk weight for unrated corporate exposures) reflecting a difference in the LGD under the foundation IRB (FIRB) approach (*i.e.*, 45% for senior debt and 90% for equity).²¹

6. Retail Portfolio

The industry believes that the flat risk-weight of 75% for regulatory retail exposures should be revisited, as we consider such a risk-weight punitive for good quality portfolios, particularly where the IRB risk-weight is generally a quarter of the proposed flat risk-weight. For commercial banks with a significant exposure towards retail counterparties (either individuals or small business) the proposal may inhibit lending to the real economy, particularly to high quality counterparties.

²¹ If the Committee were to retain a 250% risk weight for equity, we believe that because equity in the banking book may be currently held for the purpose of maintaining a long-term relationship between a bank and its corporate customer, a sufficient transition period or grandfathering provisions should be included upon implementation, considering that the Committee's proposal of a risk weight of 250% for equity is a significant increase compared to the currently applied risk weight of 100%. In addition, sale of such equity holding may require a delicate negotiation with the corporate customer who may have to revise its capital policy and/or find an alternative long-term shareholder.

The BCBS should consider the risk mitigating arrangements included in certain retail transactions, such as loans secured by receivables (e.g. commercial, service and credit card receivables, payroll payments, rents, long-term public concessions), or collateralized by durable goods (e.g. vehicles) that meet specific requirements. Indeed, we consider that, for example, the second hand car market is very liquid and countercyclical. The collateral in this area can be converted into cash in a short time frame and the sale of secondhand cars has increased over the last several years.

Risk sensitivity can also be enhanced by taking into account the maturity of the exposure (both institutional and empirical evidence has indicated that long-term credits are riskier than short-term credits) and variables directly linked to the behavior of a particular product or client and data associated with the track record of the customer available to the credit institution.

We do not agree that introducing this level of granularity to the assessment of regulatory retail exposures would add undue complexity. Indeed, most retail systems are automatic and IFRS9 will require the monitoring of potential significant credit deterioration since origination. Instead, we believe that by taking into account risk mitigating criteria, the treatment of the retail book will more closely resemble risk in the portfolio and will align better with its treatment under the IRB approach.

7. Real Estate Exposure Class

The Associations appreciate the careful review of the treatment of real estate exposures under the revised consultative document. The industry believes, however, that the Committee's re-proposal does not fully take into account significant jurisdictional differences globally for this important lending class. This will likely influence comparability considerations for banks that operate in multiple jurisdictions and will matter significantly to residential mortgage lending given that it is a large portfolio for many banks and also substantially impacted by local differences including, *inter alia*, the housing market supply and demand balance, taxation, legal considerations and risk mitigation factors. Due consideration should also be given to allowing different risk weightings across national borders based on structural differences between countries evidenced by differences in loss experience. Indeed, that would increase the comparability of risks across countries, areas, and systems. The proposals could also have a significant impact on banks providing mortgage loans to SMEs in low risk environments and could increase the capital required to be held against these safe loans, creating unfortunate obstacles for banks' ability to finance growth in the real economy.

a. Loan-to-Value ratio

The Associations generally agree with the use of the LTV ratio as a risk assessment for residential and commercial real estate. However we have identified seven areas where we believe the current proposal will potentially produce unintended outcomes or could be enhanced:

1. The proposed LTV calculation does not give full recognition to risk mitigants other than a decline in LTV associated with a conventional amortizing loan (e.g. in some jurisdictions mortgage loans are not amortized (or only to a small extent), but cash is instead invested in savings/pension plans linked to the mortgage). This is largely driven by the tax laws in the country in question.
2. Basing the LTV ratio on the original property value measured at the time of loan origination may create an incentive to change lenders, as customers would be able to benefit from pricing differences that a lower risk weighting based on current market value would lead to, given the new lender would be able to reflect any valuation increases.
3. The discretion for national supervisors to require LTV and risk weights to be recalibrated based on lower property prices introduces a pro-cyclical element to the capital requirement that would simply serve to make capital ratios appear weaker at a time when the banking system would already be under stress.
4. The lack of granularity in the LTV bands and the correspondingly large jumps in risk weights creates non-risk sensitive cliff effects that are likely to result in loans becoming grouped around borderline LTV values with no recognition of the value of lower LTV's within the existing LTV bands.
5. The risk weights for residential retail estate exposures where repayment is materially dependent on cash flows generated by property are difficult to reconcile with the observed differences in losses recorded for residential real estate and counterintuitive in some of the higher LTV bands when compared to the unsecured retail exposures' risk weight (75%).
6. The calibration of risk weights for real estate exposures should take into account the extent to which the introduction of a variable counter-cyclical capital buffers will scale up the effective risk weight at times national supervisors have identified the potential for heightened risk.
7. Some of the proposed RWs appear to conflict with the general principle in paragraph 104 of the consultation that states "no transaction in which CRM techniques are used shall receive a higher capital requirement than an otherwise identical transaction where such techniques are not used". That is particularly true with regard to commercial real estate and loans which do not meet the operational requirements included in paragraph 50.

In order to mitigate some of these effects, we suggest the risk weight tables for residential and commercial real estate exposures should be recalibrated and made more granular, specifically allowing for lower risk weights for LTV ratios less than 60%. This could be achieved by developing a blended risk weight calculation based on the loan's exposure across different loan-to-value buckets.²² This blended risk weight would increase continuously as the LTV of the

²² For example, a retail client has \$60,000 mortgage for his house with a \$100,000 value. The proposed risk weight is 30% and the bank assigns \$18,000 of RWAs. This client then applies for a \$1,000 increase of his mortgage. For this additional \$1,000 loan, the supplying bank would have to hold an additional \$3,350 of RWAs, which makes it unattractive for banks to honor such a request. Also, a fully collateralized loan of \$61,000 should not attract higher RWAs than a collateralized loan of \$60,000 and an

loan exposure increased and would enhance risk sensitivity. The Associations believe that marginal risk weights should at least not be set above 100% in order to avoid undesired outcomes.²³

b. Loan-to-income/fixed rate

It is also widely recognized that there are different business models for home loans and this includes use of Loan-to-Income / fixed rate (LTI). LTI is based on three principles; the loan has a fixed rate, the credit decision is made by the bank based on the ability of the client to repay the loan, and the value of property in question only comes to the size of the value of the cash portion of the loan that must be paid at the time of the loan to be accepted. We believe that this different business model for real estate exposures should be taken into account by the Committee in the context of their review. Namely, we believe the current proposal could penalize banks utilizing an LTI model and could lead to higher RWAs in this area, negatively impacting customers and we welcome further dialogue with the Committee as discussions progress in this area.

c. Property development risk weight

The Associations believe that the flat property development risk weight should be revisited as an opportunity to increase risk sensitivity. As such, security value, with tiering based on the LTV ratio should be taken into account. Furthermore, risk reducing techniques such as 'pre-selling' should also be recognized and an ongoing risk assessment over the life of the project should be allowed to reduce capital requirements with reductions in risk.

uncollateralized loan of \$1,000 to the same counterparty. The cliff effects around the 80%, 90% and 100% LTV points are even more punitive, even exceeding a 100% risk weight. Another problem of the proposed mechanism concerns a situation where another retail client has a similar house of \$100,000 and has a first mortgage of \$60,000 with Bank A and a second mortgage of \$22,000 with Bank B. In the current consultative proposal, both banks would have to apply a 45% risk weight, although Bank B has a riskier tranche than Bank A. Also Bank A would need information from Bank B on further developments of the second mortgage: If the client would redeem \$2,000 of his second mortgage, the risk weight should be changed to 35%. However, it is unclear how Bank A would know this. Both issues raised in these examples can be solved by using graduating risk weights, as shown in the hypothetical outline below. This would also better reflect the fact that the lowest LTV part of a mortgage is not as risky as the highest (as the current proposal assumes). Please note, however, that these RWs are not a recommendation but purely an example. We believe that numbers on such RWs need to be calibrated in line with data from the pending QIS, and we look forward to discussing this with the Committee in due course.

- 25% risk weight for the part of the mortgage up to a LTV of 40%,
- 30% risk weight for any part of the mortgage between a LTV of 40% and 60%,
- 35% risk weight for any part of the mortgage between a LTV of 60% and 80%,
- 45% risk weight for any part of the mortgage between a LTV of 80% and 90%,
- 55% risk weight for any part of the mortgage between a LTV of 90% and 100%,
- 75%* risk weight for any part of the mortgage above a LTV of 100%.

* 85% for SME

²³ Additionally, we would be grateful for dialogue with the Committee on potential capacity for the LTV ratio to reflect the value of rising property prices in order to address and mitigate the risk of the unproductive and costly migration of customers refinancing loans to take advantage of the decline in risk weights that would be available to banks writing new loans.

d. Finished property

In reference to the proposals of Paragraph 50 of the consultative document, we believe the requirement of “finished property” should be removed and the Committee should maintain the current requirement on residential property that the property is or shall be occupied or let by the owner, or the beneficial owner in the case of personal investment companies. We believe this constitutes a better assessment of risk in the proposal.

We also believe that residential buildings under construction should be allowed to apply the risk-weight tables in 9, 10, 11 and 12. The inclusion of uncompleted building is a matter of timing and on completion such properties would be eligible. The risk of project non-completion can be mitigated by introducing additional criteria such as a detailed policy on developer approval, project approval and risk management procedures (e.g. concentration caps, developer approval criteria). This would be the preferred approach to avoid an extra complication to the capital computation process. An unintended consequence of the higher risk weight for residential buildings under construction is that this would have a negative socio-economic impact. The higher risk weight would lead to an increase in mortgage pricing for consumers and would discourage the purchase of new residential properties under construction.

Alternatively, national supervisors should be allowed to apply their discretion without any imposed conditions. Imposed conditions do not reflect the economic realities in certain jurisdictions where multiple family units/structures are common and the entire household contributes to the family living expenses. There are also more relevant factors which would be considered by national supervisors such as the legal infrastructure and the re-sale market which are part of the requirements in paragraph 50.

e. Buy-to-Let

We are particularly concerned about the difference in proposed risk weights for regular mortgages (where ‘repayments are not materially dependent on cash flows generated by the property’) of 25% -55% to the possible risk weights for Buy-to-Let (“BTL”) (where ‘repayments are materially dependent on cash flows generated by the property’) of 70% - 120%, which we believe does not match industry experience in terms of credit risk when dealing with this type of lending category. In some jurisdictions, core BTL lending typically involves high financial quality landlords with high income streams and other assets as part of their portfolio, where the ultimate risk levels are regarded as being at least on par with residential mortgage lending. We acknowledge that there may be some cases, such as investments in residential property by corporates or special purpose vehicles (SPVs), where the proposed treatment in the consultation may be valid, but we urge caution in ensuring that same treatment is not inappropriately applied to quality retail customers that have a residential property within their investment portfolio. As such, we suggest including conditions which, if met, would allow the use of the lower regular mortgage risk weights for high quality BTL lending. If the intention of

the Committee is that the risk weights be applied more broadly to BTL lending and not just to higher risk outlier segments, then it is critical that the risk weights in Table 10 of the consultative document be recalibrated.

Guidance on how the term “materially dependent” should be interpreted will also be critical to ensuring that that a substantial increase in risk weights is restricted to outlier segments of the residential real estate loan portfolio that exhibit higher loss experience commensurate with the higher risk weights. The test for material dependence could, for example, be based on determining if the loan would still meet the required standard for debt service coverage with a haircut applied to rental cash flows or by meeting a general threshold with respect to the ratio of rental cash flows to total cash flows. The precise level of that haircut would define the extent to which loan repayment was materially dependent. We suggest that a haircut of 25-30% to rental cash flow would be appropriate. In particular, it addresses the fact that a high level of rental income is not a problem *per se* and may in fact characterize high quality lending.

f. Land Acquisition, Development and Construction

The industry has some concerns with the treatment of Land Acquisition, Development and Construction (“ADC”), particularly as the RW would appear to imply the Committee considers the underlying risk is commensurate with higher risk categories, including defaulted exposures. As such, we would appreciate clarity on the types of exposures that should be classified as land acquisition. The Associations propose that only those exposures that are Special Purpose Entity (“SPE”)/ Special Purpose Vehicle (“SPV”), or legal structures similar to an SPE/SPV, should be classed within this category. A non-SPE/SPV should receive the same RWA treatment as the corporate entity to which the debt has been provided as the repayment, and therefore the risk, will be based on the trading of the corporate entity.

The industry would also like to clarify that the definition of ADC would capture any interest-only lending secured by real estate where repayment is from the future uncertain sale of the property. This is regardless of the type of lending and will include interest-only loans to social housing providers, (as footnote 50 would only allow the general treatment to be applied to capital repayment loans) and owner-occupied and BTL mortgages to high financial quality landlords. We would welcome clarity on this definition as we believe it is intended to, and should only apply to, speculative investment lending.

In addition, the Committee states that the ADC loan risk weight treatment relies on the fact that the source of repayment at origination of the exposure is either the future uncertain sale of the property or cash flows whose source of repayment is substantially uncertain. However, we believe that after the demonstration that the future sale of property or future cash-flows to allow repayment of the loan is *not* substantially uncertain, the Committee should apply a RW of 100%, which we believe is a more appropriate level for this situation.

This demonstration will be based on the proof of the immediate transfer of the legal ownership from the developer to the buyer(s) through signed notarial act, even though the building is not completed, and the presence of a bank completion guarantee. Such practice protects all parties (developers, bankers and final buyers) with the presence of signed sales/signed leases as a previous condition. Such signed sales or leases are one of the key elements to secure the transaction (together with the equity and the developer's margin), to validate the "adequacy" of the asset within its market and to demonstrate the likelihood of the future sales coming from the residual stock and their future related cash flows.

g. Residual inconsistencies

There are some outstanding inconsistencies present in the current consultative proposal in relation to real estate lending. First, the combination of footnote 48 and paragraphs 55 and 59 seems to imply that an unsecured loan to individuals or SMEs can have a lower weight than a loan secured by ineligible collateral. Second, a corporate mortgage on an unfinished property is always considered ADC and weighted at 150%, while unsecured loans to construction companies can have a lower weight following the counterparty weight (thus introducing a perverse business incentive). Third, footnotes 48 and 51 assign an 85% risk weight to retail SMEs where the LTV is greater than 100%, which we note is a higher risk weight than assigned to unsecured retail SME lending. Fourth, footnote 46 should explicitly allow the valuation be conducted by an independent party, as the current wording could be read to mean any valuation conducted at the time of the bank's mortgage acquisition, loan processing or loan decision process is not permitted to be used in the LTV. Further clarification in these areas by the Committee would prove helpful.

8. Risk Weight Add-on for Exposures with Currency Mismatch

Through the consultative document, the Committee intends to extend the application of the risk weight add-on to the corporate portfolio. Specifically, banks would apply a 50% risk weight add-on to "unhedged exposures" with currency mismatch, where "unhedged exposure" is defined as an exposure to a borrower that has no natural or financial hedge against the foreign exchange risk arising from the currency mismatch. We believe requiring an add-on in this regard is not appropriate due to the fact that such credit risk is already incorporated as part of the external rating and due diligence practices, as well as for the investment grade qualification previously outlined in the consultation, and so it will lead to double counting of such risk.²⁴

As currently proposed, banks will have to check and keep a detailed audit trail for each facility to ensure that there is no currency mismatch, which will entail highly burdensome level of due

²⁴ A question also remains on whether the currency mismatch add-on is meant to imply a flat 50 percentage point add-on to the base risk weight or an add-on of 50% of the base risk weight. If the first interpretation is correct, this would have a disproportionate effect on high-quality exposures (retail mortgages with LTVs below 40% would, for example, increase from a 25% risk weight to a 75% risk weight, effectively equating them to mortgages with an LTV of over 100%). On the other hand, a corporate rated below BB- would effectively not get any add-on due to the ceiling of 150% for the risk. We would appreciate clarification on this point.

diligence that could be untenable, especially for certain SME portfolios. The proposal also does not introduce any proportionality. For example, if a corporate has its main revenues, but not all, in a given currency (for instance US dollars (“USD”)), it means that any loan in a different currency, whatever the amount, will be subject to an additional RW. A loan in USD to a counterparty whose main revenues are in Euros will be subject to an additional RW, whereas a loan in Euros to the same counterparty who makes a cross currency swap Euros or USD will have no additional RW while the risk of default is the same for the lender. Such additional requirements will induce an increase in the financing cost for middle market corporates who wish to borrow foreign currency to develop their activity in new foreign markets where they do not yet have existing revenues. Overall, this will increase the complexity of the framework while the benefit is unclear.²⁵

The add-on could also have a relevant negative impact in emerging economies. We consider that the proposal should take into account that companies from dollarized economies, such as those in Latin America, can transfer this currency risk to their customers and suppliers. Lending to high net worth individuals (irrespective of whether they are classified as corporate or retail exposures) with income streams from multiple currencies would also be impacted and from experience this customer segment has very low default rates and consideration should be given to an exemption for this segment.

Lastly, it is not obvious why the haircut for a currency mismatch in the Credit Risk Mitigation (“CRM”) framework is 8% while the increase in risk weights for real estate exposures is suggested to be 50% (or 50% of the base risk weight). Even allowing for the longer holding period due to lower liquidity of the collateral, it seems that additional analysis and clarification would be warranted in this area.

9. Off-balance Sheet Exposures

Credit conversion factors apply to off balance sheet (“OBS”) instruments that are key financing tools for consumers and businesses. Such products are a prevalent feature in lending spaces such as project, trade and commodities finance. They provide additional liquidity to meet customers’ financing demands, help avoid pro-cyclical effects that can occur in liquidity stress conditions and represent an important portion of financial firms’ banking books.

While the industry supports the Committee’s general goals of updating current SA CCFs and increasing alignment between CCFs under the Standardized and IRB approaches, we believe CCF levels proposed in the consultative document are overly conservative and may have

²⁵ In addition, the proposed approach may overstate risk in the system. Expanding on the above example, if the borrower of the loan hedges its currency risk using a currency swap with separate bank counterparty, there is no reasonable way the lending bank can be aware of the currency swap into which the borrower has entered. Similarly, the bank that has entered into the currency swap with the borrower has no reasonable way to know that the derivative is hedged by the loan. Therefore, both the bank that has provided the loan and the bank that has engaged in the currency swap will have to calculate higher RWAs, thereby overstating RWAs in the system.

adverse impacts on banks' lending activities. This could, in turn, negatively impact the clients that rely on the associated products by limiting their availability or accessibility through increased costs of payment and financing facilities for retail customers and for working capital funding for both SME and larger corporate firms. Moreover, the proposed changes are among the most significant when compared to the current SA calibration and appear to be inconsistent with the goal of the Committee in avoiding increases in capital requirements.

The levels proposed in the consultation are not reflective of available industry data or experience. We respectfully caution against relying too heavily on previous QIS data that may not be fully reflective of underlying risk levels due to definitional and regional segmentation issues. We would therefore welcome further discussion with the BCBS on the basis of available industry data on CCFs and recommend that a more in depth analysis of this data be undertaken before the SA proposals are finalized. We believe this is particularly relevant and timely as the BCBS is due to consider CCFs in the context of internal models. Indeed, the impacts of the SA proposal, we believe, would also be amplified should these SA CCFs become binding constraints on IRB banks. In our view, they would therefore neither be appropriate for use as the basis for an output floor for IRB firms, nor as an alternative to internal modelling of CCFs. We do understand that these issues will form part of separate consultations and we look forward to engaging with the BCBS through these; however, we consider that a holistic approach across the Basel framework would be largely preferable and result in more meaningful outcomes and consistent treatment of CCFs throughout the various approaches.²⁶

While the industry generally agrees with the overall hierarchy of the proposed CCF levels in the consultation, industry data indicates that these proposed levels are far too high. We therefore propose segmentation along the following lines - with CCFs calibrated accordingly - with our reasoning set out below.

²⁶ The Associations wish to stress that the SA treatment of OBS exposures is a crucial part of the broader, ongoing work to ensure RWA accuracy which includes not only the possible introduction of capital floors but also potential changes to the future use of internal modelling for CCFs. SA CCFs are also referred to in the calculation of the leverage ratio for the determination of the leverage exposure for off balance sheet items. Increasing SA CCFs will therefore also impact the leverage ratio and the magnitude of this impact could be significant. Given these interconnections across the framework, it is extremely difficult to correctly design, calibrate and reflect on the impacts of one aspect of the CCF framework without this holistic view of the full set of proposals that relate to CCFs.

Segment	CCF
Unconditionally cancellable commitments (UCCs)	
Retail	0%
Corporate	0%
Contingent facilities	
Short term self-liquidating trade letters of credit arising from the movement of goods	20%
Certain other transaction related contingent items	50%
Cash commitments, retaining a differentiation according to the current maturity distinction (less than and over 1 year) and split by retail and corporate	
Corporate, split by underlying product type (e.g. term loans, revolving, and with term loans received a lower CCF than revolving facilities)	42-54% depending on product

a. Relevant risk drivers in determining appropriate CCF treatment

The Associations believe that the treatment of CCFs should be further considered and broken down according to the following risk drivers to determine the appropriate segmentation, which forms the basis for our alternative proposals above:

- The type of commitment, e.g. cash commitments versus contingent facilities (transaction related contingencies);
- Whether the facility is unconditionally cancellable or not – contractual and legal environments make an economic difference which must be recognised;
- The type of counterparty to which the facility is granted, bearing in mind that CCFs are applicable to products aimed at all types of customer bases. For example current accounts (overdrafts) are used by both non-retail and retail clients. Term and revolving loans, are again used by non-retail and retail clients (including credit cards). Guarantees, letters of credit, and facilities to provide these products are used by non-retail clients;
- The residual maturity of the underlying facility also has an impact on the level of CCF associated with a facility

b. Cash commitments and contingent facilities

Within OBS commitments, there is a need to distinguish between cash commitments and contingent facilities. Cash commitments can be unconditionally cancellable, conditionally cancellable (e.g. cancellation in case of a deterioration in credit quality) or not cancellable on the part of the lender (as noted below).

In the case of cash commitments, the CCF is effectively an estimate of how likely and to what extent the “credit line” will be used. There are different types of cash commitments, including those for the provision of revolving facilities and term loans, with those for term loans exhibiting different, (lower) draw down characteristics to those for revolving loans.

We understand that the Committee assumes that the level of drawing of certain recurring loan facilities is highest immediately before a default. This may be an appropriate assumption for certain types of lending but is not the industry’s experience when it comes to larger corporates, and trade and receivables financing in particular. For the latter, the level of drawdown is particularly influenced by business volumes that enable a company to obtain more funding for increased sales and trade volumes. These often reduce before a company would go into default and therefore the assertion of a high level of drawdown before default is not evidenced in our data history. In other words, drawdowns depend on the client’s business cycle rather than on its credit quality. A good example of this is cash pooling arrangements with large corporates or insurance firms to provide liquidity in times of peak demand. Contingent facilities include guarantees and letters of credit and are prevalent in the corporate space, particularly in trade and commodity finance. These types of off-balance sheet exposures exhibit much lower credit risks, including risks of drawing, compared for instance with cash commitments such as revolving credit facilities or term loans, and should therefore attract significantly lower CCFs. Moreover, documentary letters of credit and guarantees are issued in relation to specific contracts or commitments and cannot be used to generate liquidity ahead of a potential default. As such, increased utilization prior to default should not be expected. Other types of guarantees include performance guarantees for building projects or those where conversion is unrelated to the credit quality of the client (e.g. guarantees if a client loses in litigation).

c. Trade finance instruments

Another issue which requires clarity relates to trade finance OBS items. We understand that no change has been proposed to the CCF for short-term self-liquidating letters of credit arising from movement of goods or to the CCF for transaction related contingent items and these products will continue to receive CCF treatment of 20% and 50% respectively. However, we recommend that explicit guidance be provided on the CCFs applied to off-balance sheet trade finance exposures (e.g. import L/C, export L/C confirmations, acceptances and guarantees) and officially supported export credits when these products are structured as committed facilities/limits.

These terms are often used interchangeably to reflect practices within banks and, in line with both regulatory intent and banking practice, the CCF for these facilities should be the exposure/product based CCF of 20% and 50%. We also note that such clarification will provide consistency with paragraph 70 of the consultative document, which states that when there is a commitment to provide an off-balance sheet item, banks are to apply the lower of the two applicable CCFs (e.g. when import L/C, export L/C confirmations and guarantees are structured as commitments/limits/facilities then the product based CCF of 20% and 50% will still apply).

d. Unconditionally cancellable commitments

There are many cases where the terms and conditions of facilities enable firms to suspend their commitments, or where the product requires the banks' authorization before the client can make use of the facility (which may be considered in some jurisdictions as not being a commitment at all), and where consumer protection laws or other laws do not have an influence on the lenders' decision-making powers. This is particularly true in the corporate space, but can equally be the case in the consumer space where the impact of consumer protection laws does not change the nature of the commitment from being unconditionally cancellable. In such cases, reputational risk considerations do not constrain the firm in its ability to unilaterally cancel these commitments. For product types that truly allow the bank to cancel the facility at any time in practice and where there are demonstrable controls and legal rights, monitored through robust internal governance, a 0% CCF is fully justified. In other words, all of these situations are cases where commitments are truly unconditionally cancellable and should receive a 0% CCF.

Imposing a non-0% CCF to UCCs would in substance equate to imposing capital requirements on exposures that could only materialise at the unilateral discretion of a bank. Moreover, in many jurisdictions these types of commitments are not recognised in banks' financial statements and the principle of aligning prudential exposures on accounting figures should be maintained going forward. If 0% CCFs are removed for UCCs, banks would no longer have any incentive to issue unconditionally cancelable commitments. We stress that UCCs are typically favorably priced, for the benefit of clients and as such this may no longer be possible going forward.²⁷

e. Data issues to consider in CCF calibration

Industry data from GCD also shows the difference between CCFs between revolving, term loan and other facilities for corporate clients:

²⁷ Examples include: UCCs to corporates and SMEs that are closely and continuously monitored and whereby banks can unilaterally cancel or limit additional drawdowns when they identify any sign of deterioration in the creditworthiness of borrower - similar UCCs are prevalent in the retail credit cards space; undrawn commitments to finance receivables where customer facility documentation allows the reduction or cancellation of further draw-downs or requires repayment of existing draw-downs; credit facilities granted to high net worth individuals are typically secured by eligible collateral and can comprise portfolio finance facilities, real estate mortgage loan facilities, life insurance premium financing facilities and standby letter of credit facilities. The terms and conditions of these credit facilities typically allow a firm to unconditionally cancel and withdraw any facility or undrawn portion of a facility at any time. The firm reserves the right to decline any requested drawdown and may at any time and without prior notice terminate facilities at its discretion. Lending provided to such clients does not fall under the BCBS retail definition as the volumes are typically above EUR 1 million or transacted through an SPV or trust; retail credit card commitments where consumer protection laws and regulations that govern the lender's ability to restrict a customer's right to draw on the unused portion of a credit card line require only that the lender provide after-the-fact notice that customer's line has been cancelled or reduced; trade and commodity product customer limits that apply to trade and commodity finance instruments such as letters of credits and guarantees advised to customers but that have not yet been utilized. For example, if a letter of credit (L/C) facility is uncommitted, this means the bank has no obligation to issue any L/C the customer asks it to issue. The bank can refuse to issue for any reason and without any obligation to give reasons. Any "limits" stated in the documentation for this type of facility are not amounts up to which the bank has committed to provide the facilities but an indication of the bank's maximum potential appetite for providing that type of facility to that customer. They do not bind the bank in any way.

Facility type	# of facilities	CCF3, arithmetic mean
Revolving	6015	54%
Term loan	4298	42%
Other (includes contingent facilities & products where classification not reported)	3226	30%
All	13539	45%

The Associations would welcome the opportunity to present and discuss this data with the BCBS in more detail and recommend that it be taken into account when calibrating final CCF levels for the SA.

CCF distributions, for all commitments (other than UCCs) *i.e.* including both cash commitments and contingent facilities are bimodal. For contingent facilities, they will either be equal to 0% (the guarantee is not be called), or equal to 100% (when the guarantee is called). For cash commitments, they will either be 0% (not utilized) or vary between 0% and 100%. Calibration of CCFs therefore needs to be granular and product based to recognize that there are many “zero case” draw-downs. The BCBS should carefully reflect the bimodal distribution of CCF levels, recognising that in a significant portion of all cases, they are equal to 0%.²⁸

10. Defaulted Exposures

The Associations agree with the Committee on the desire to align the treatment of defaulted exposures in the SA with that under the IRB approach and we believe that credit risk mitigation techniques should apply consistently to both defaulted and non-defaulted exposures. We welcome in particular the change in terminology from ‘past due’ to ‘in default’, which we agree is a better indicator for this exposure class.

We do, however, disagree with the proposed risk weighting for the unsecured, un-provisioned part of the exposure at a flat 150% (100% for residential real estate exposures). This is due to the fact that capital and provisions are the total reserves for loss absorption, so capital requirements should consider the total level of provisions; higher capital requirements over defaulted exposures are insufficient to cover shortfalls in provisions. They also penalize banks with more conservative provisions and worsen the problem of pro-cyclicality; and unlike the IRB approach, where deficits in provisions are corrected by capital deductions, solvency indicators in the SA end up being worse for more conservative banks in provisioning. These differences are not compensated by considering exposures net of provisions.

We would suggest aligning the treatment of exposures with the IRB approach in this regard as well – especially since the Committee makes the point that provisions are supposed to cover expected losses, while capital covers unexpected losses. It is important to note that

²⁸ GCD data referenced in Appendix 3 shows the bimodal nature of CCFs (for all types of corporate commitments and underlying facilities taken together).

unexpected loss stems from the volatility of the risk parameters underlying the capital calculations, which in the IRB approach are PD, LGD and EAD. While all three parameters are subject to volatility for performing exposures, only LGD is still subject to volatility at default. PD (at 100%) and EAD are no longer uncertain. This is reflected in the IRB formula for the calculation of capital, which returns a capital requirement of zero when a PD of 100% is inserted.

As a result, only the potential volatility of LGD has to be covered by capital requirements for defaulted exposures. In the IRB approach, this is done by calculating the difference between the LGD of the defaulted exposure and the bank's best estimate of LGD for this exposure and requiring capital in the amount of any positive difference between the two measures. Therefore, capital is only required for defaulted exposures whose best estimate LGD is lower than the original LGD. In contrast, in the standardized approach, the capital charge for defaulted exposures applies to all exposures, giving rise to a potentially significant difference in the actual scope of application of the charges and therefore on the magnitude of the total capital requirements for defaulted exposures.

Consequently, the risk weight applied to exposures in the SA should be calibrated to reflect the potential variability of losses for these exposures, over and above the amounts already provisioned, thus avoiding double counting. In order to preserve alignment with the IRB approach, the calibration should consider the fact that capital is not required for all defaulted exposures under IRB, while it applies to all defaulted exposures under the SA.

As losses occur only over defaulted exposures, capital adequacy should consider the entire portfolio, instead of only defaulted exposures for the purpose of calibrating the RW. We believe the QIS data will provide valuable information in this regard, which should be carefully considered by the Committee in their review.

The Committee might temporarily retain a link to the level of provisions (*i.e.* lower risk weights for banks with high levels of provisions) until convergence to expected loss provisioning is further advanced, however a revision to the 20% threshold might be necessary because of the change from past due to defaulted.

11. Credit Risk Mitigation Framework

The Associations welcome the Committee's commitment to retain external ratings in the CRM framework in its efforts to promote risk sensitivity and reduce complexity. Furthermore, we strongly support the proposed changes to the formula used for the measurement of exposures to securities financing transactions ("SFT"). This includes changes which permit firms to net loans and offsetting collateral, the use of a factor to approximate the impact of correlation on a market-wide basis, and the use of a factor to approximate the impact of portfolio diversification (with an adjustment for certain less significant securities issuances). These are all important improvements addressing the most significant limitations in the existing Comprehensive Approach which materially improve the overall risk sensitivity of the framework for SFTs. Industry estimates are that the revised methodology produces exposure amounts which are

seven to ten times greater than simple value-at-risk (“VaR”) methodologies. This compares with exposure amounts using the existing Comprehensive Approach which are twenty five to thirty times greater than simple VaR. Taking improvements into account; however, we do note several areas herein for further review by the Committee.

a. Proposed removal of models for calculating exposures for derivatives and SFTs

The consultative document would remove the current possibility that firms have to use the Internal Model Method (“IMM”) or VaR to calculate counterparty exposures for Over the Counter (“OTC”) derivatives and SFTs under the standardized approach. The Associations disagree with this proposal as it would significantly increase capital requirements for impacted firms which we believe is not the intention of the BCBS. In our view there is no fundamental reason to link IMM or VaR approval with IRB approval.

It is important to recall that internal credit risk modelling (*i.e.* IRB approaches) and IMM or VaR modelling have different purposes and are based on different data and assumptions. IRB requires the development of an internal framework to assess the credit quality of counterparties, using obligor, default and recovery data. IMM or VaR modelling is more akin to market risk modelling, requiring similar capabilities to estimate the future distribution of exposures by modelling movements in market risk factors. Investment in IRB modeling methodology may not be warranted for firms with a trading focus and a limited lending business. For such firms with predominantly low default portfolios, exposure modeling (IMM/VaR) rather than counterparty default modelling (IRB) is more important from a risk management perspective. Where these standardized approach firms enhance their risk management and measurement capabilities by developing market risk modeling methodologies for their trading book positions and OTC/SFT counterparty exposures and meet the high approval standards and stringent backtesting requirements required to obtain permission to use these models in their RWA calculations, these permissions should remain. Withdrawing the possibility for these firms to use their IMM or VaR models could reduce incentives for firms to invest in risk measurement methodologies. We therefore urge the BCBS to reconsider this aspect of the consultation.

As with other areas of the consultative document, there is also a need to consider the implications of forthcoming BCBS proposals in the area of IRB modelling together with these suggested changes. Removal of certain portfolios from IRB could result in exclusion of these portfolios from IMM or VaR as a result of the interaction with the SA proposal, further increasing capital requirements across the industry to the detriment of certain lending activity.

b. Treatment of securities financing transactions under the Comprehensive Approach

As noted above, the industry welcomes the proposal for the amended formula for the measurement of SFT exposures under the Comprehensive Approach.

Nevertheless, we wish to point out that the BCBS uses the terms “repo-style” and “SFT” transactions interchangeably in its consultative document. However, these two terms are not

synonyms, with SFTs covering a broader range of transactions, including repo-style but also margin loans. We do not see any justification for limiting the new proposals to only repo-style SFTs and recommend clarification that the revised formula is meant to apply to all SFTs and is not limited to repo-style transactions.

Furthermore, we suggest an adjustment to the criteria used to exclude smaller securities issuances from the netting set 'N', so that it is based on the average size of all securities issuances within the netting set, rather than in relation to the largest securities issuance. This is designed to account for netting sets that include sovereign debt securities where there may be a small number of very high value trades that can otherwise obscure the presence of an appropriately diversified series of transactions. As an example, the Committee may wish to establish a threshold set at 20% of the average size of all securities issuances, thereby resulting in a more proportional view of the relative size of securities issuances within the netting set "N" that is nonetheless consistent with the Committee's underlying policy intent.

Lastly, we note that the Committee has decided to keep the read-across to Annex 4 paragraphs 41(i) and (ii) in paragraph 157 of the consultative document. The application of supervisory floors for the margin period of risk has a significant impact on haircuts and is in our view subjective, especially with respect to defining illiquid collateral. While this is acceptable for modelling EAD under the scrutiny of model permission processes, we do not believe these rules are sufficiently defined for the application under the SA.

Therefore, we recommend that the Committee define "illiquid collateral" for the purpose of the comprehensive method for SFT transactions instead of referring to standards that are designed for banks that model EAD exposures under their model permissions. This will be consistent with the stated desire to remove complexity and subjectivity from standardised calculations.

c. Minimum holding period for margin lending

Banks offer a Prime Brokerage ("PB") service to hedge funds and other alternative asset managers and part of the service is to advance financing on a secured basis known as margin lending. As part of the PB offering, banks also lend securities to the same clients. Both the financing of the client's long securities and covering of their short positions are covered by the same agreement, a 'Prime Broker Agreement' ("PBA"). This PBA offers the banks the same support as a regular Master Repo Agreement, and other similar agreements utilized for SFTs. Banks support the PB funding requirements with general SFTs, creating a 'Matched Book' for funding purposes (*i.e.* banks fund PB clients long in the repo market, and cover PB clients short by borrowing securities from the stock loan market).

Banks view the PB financing activity in the same way as they do other SFT activities. For this reason we see margin lending relating to Prime Brokerage activity as the same as other SFT repo-style transactions with respect to counterparty credit risk. However, paragraph 155 of the consultative document suggests a differentiation between margin lending and repo-style transactions for a minimum holding period. This is inconsistent with IMM and Leverage Ratio

exposure measure calculation rules where margin lending is treated consistently with other SFT transactions.

We therefore respectfully recommend that the Committee remove this inconsistency and simplify the standard by classifying margin lending under the condition of daily remarking together with repo-style transactions under the general heading “SFT”.

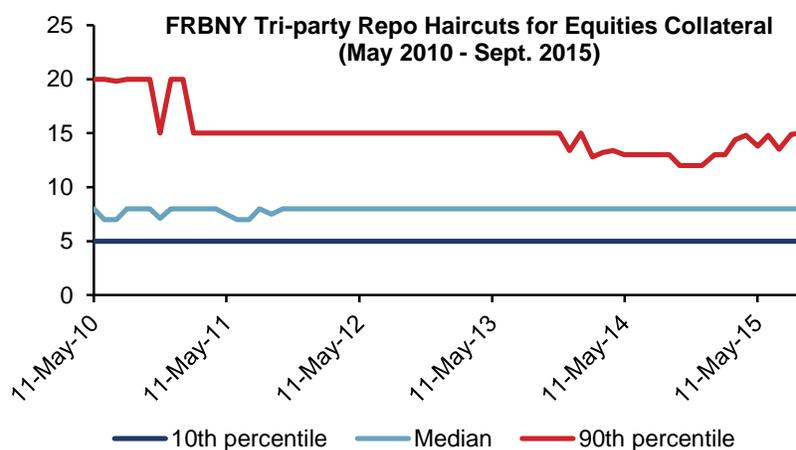
d. Proposed collateral haircuts

(i.) Equity securities

The consultative document sets out haircuts that are higher than those demanded by the market for SFTs even during periods of stress, particularly for equities collateral. Indeed, available data from the FSB and the Federal Reserve Bank of New York reflect much lower haircuts than those given in the proposal:

Basel equity haircuts vs. FSB study	Current SA equity haircuts (%)	Revised SA equity haircuts (%)	FSB study equity haircuts (%)
Main index equities	15.0	20.0	13.8
Other equities	25.0	30.0	17.5

Source: FSB’s *Strengthening Oversight and Regulation of Shadow Banking: Regulatory Framework for Haircuts on Non-Centrally Cleared Securities Financing Transactions* (14 Oct. 2014)



Source: Federal Reserve Bank of New York Tri-party Repo Statistical Data

The BCBS’s proposed recalibration appears to be unjustified in light of this data. We note in particular that higher haircuts for equity securities will disproportionately impact SFTs (repos and margin loans) relative to derivatives which are generally not collateralized by equities. Moreover, these higher haircuts do not reflect the effects of SFT regulation in other areas (e.g. FSB minimum haircuts, leverage ratio, liquidity requirements, etc.) and the cumulative impact is disproportionate to their risk.

(ii.) *Non-investment grade collateral*

While setting out more granular haircut buckets, the proposal does not allow for any recognition of non-investment grade collateral, creating a cliff effect between investment and non-investment grade collateral. In order to improve the risk sensitivity of the proposals, we recommend that the CRM capacity of non-investment grade securities be recognised through an appropriately calibrated haircut level.

Indeed, analysis of non-investment grade bond ETFs indicates that prices of these securities have remained relatively stable, even during stressed periods. The iShares iBoxx \$ High Yield Corporate Bond Fund (“HYG”) and the SPDR Barclays Capital High Yield Bond ETF (“JNK”) are the largest non-investment grade corporate bond ETFs. Daily price movements of the ETFs were examined from 2007 to present to ensure that price movements through the cycle were observed. The analysis measured the historical price volatility of these ETFs over a rolling 10-day holding period, at a 90th, 95th, and 99th percentile.²⁹ Only the 10-day periods with negative price movements were used.

The table below shows the size of these negative moves at the different percentiles. For example, across all negative 10-day moves, 90% of the time, HYG’s and JNK’s prices declined by less than 3.7% and 3.9%, respectively. Similarly, across all negative 10-day moves, 99% of the time, the HYG and JNK declined by less than 12.1% and 12.2%, respectively.

Historical Price Volatility (10-day Price Change) of Non-Investment Grade Bond ETFs

Neg. Days Only	HYG (Non-IG Bonds)	JNK (Non-IG Bonds)
90th Percentile	-3.7%	-3.9%
95th Percentile	-5.5%	-6.0%
99th Percentile	-12.1%	-12.2%
Median	-1.1%	-1.1%

The analysis indicates that the historical 10-day price volatility of non-investment grade corporate bonds warrants a haircut below 15%.³⁰ However, given the novelty of recognizing

²⁹ The Basel III framework requires a 10 business day holding period for standard supervisory haircuts and a 99th confidence interval for own-estimate haircuts.

³⁰ The Associations welcome the opportunity to discuss all underlying data and calculations at the request of the Committee.

non-investment grade securities as collateral, we propose that non-investment grade securities receive a 25% haircut to conservatively account for potential price declines. Even under the most stressed conditions, this haircut is nearly double the actual price volatility of these securities. The calibration of this haircut can be revisited going forward to determine whether further reductions are appropriate.

e. Funds eligible as financial collateral

The recognition of funds eligible as financial collateral should be updated. The consultative document carries over the proposal that only funds limited to investing in instruments eligible as financial collateral under the Simple Approach are accepted, thereby excluding funds whose mandate does not prevent the manager from investing in non-eligible collaterals. We propose that developments from the BCBS' "Capital requirements for banks' equity investments in funds" be reflected in the SA. In this context, funds would be eligible as financial collateral up to the portion effectively invested in eligible collaterals (when using Look-Through Approach ("LTA")) or, when look-through is not possible, to the minimum extent limited to invest in eligible collaterals under the fund's mandate (Mandate-Based Approach ("MBA")). The ineligible portion would be disregarded.

In the same way, even though the Simple Approach already defines the substitution for the weighted average risk weight applied to the fund under the framework (LTA or MBA), the Comprehensive Approach does not allow the MBA, suggesting instead the application of the highest haircut applicable under the mandate. For instance, when a fund's mandate defines that it must invest at least 80% in eligible sovereign bonds and the rest in equities listed on a recognized exchange, the haircut applied to the collateral will be 30%. Instead, we believe it would be more appropriate to use a weighted average of the highest haircuts applicable under the mandate, which would be 18% ($15\% \times 80\% + 30\% \times [1-80\%]$). Therefore, when the LTA is not possible, we propose that the Committee consider applying the weighted average of the highest haircuts applicable under the mandate to funds under the Comprehensive Approach.

f. Credit derivatives where restructuring is not specified as an event

The consultative document proposes that credit default swaps ("CDS") where restructuring is not specified as an event be recognized as a credit risk mitigation instrument with a haircut of 40%, as opposed to the 2014 consultation where they were omitted. While this is a welcome improvement, the Associations believe that, given other boundary conditions, CDSs where restructuring is not specified should be fully CRM eligible for CRM purposes (when appropriate criteria are met, as noted below) and not subject to the 40% haircut.

Indeed, restructuring is not specified in all jurisdictions, and this is the case in the US in particular. Given the effectiveness of use of Chapter 11 bankruptcy rules in the US, an event that may lead to a restructuring credit event with respect to a non-US corporate will instead trigger a bankruptcy event for a US corporate. We note that there has only been one restructuring credit event in the US in the past ten years. The credit events that occurred over this time frame have been covered under the bankruptcy or failure to pay credit events.

It is important to note that the existing haircut will not only affect US banks, but also has an impact on the global banks that trade US CDS using No Restructuring contracts. In fact, global banks are active participants in the US CDS market due to sizeable loan commitments made in this jurisdiction. Of the USD 400 billion net notional top 1000 corporate CDS market, that are centrally cleared according to Depository Trust and Clearing Corporation (DTCC), around 50% is traded in the US, with 40% of trades executed in the EU and the remaining 10% in other countries. We therefore propose that the Committee consider the following adjustment to the consultation:

When hedging corporate exposures, the Restructuring Credit Event is not required provided that:

1. A 100% vote is needed to amend maturity, principal, coupon, currency or seniority status of the Corporate Exposure;
2. The legal domicile in which the corporate exposure is governed has a well-established bankruptcy code that allows for a company to reorganize/restructure and provides for an orderly settlement of creditor claims.

If these conditions are not met, then the current 40% haircut for hedges without restructuring would apply.³¹

g. Maturity adjustment for short term transactions

When calculating the risk weight for fully-collateralized capital market driven transactions (e.g. securities financing transactions) the IRB approach allows banks to apply an effective maturity adjustment of less than one year subject to meeting certain conditions. These conditions include daily revaluation, daily re-margining and the prompt liquidation or setoff of collateral in the event of default.³² The maturity adjustment in the IRB approach reduces the risk weight for short term transactions and reflects empirical evidence which indicates that short-term credits are less risky than long-term credits.

However, the standardized approach does not have maturity adjustments as provided for in the IRB approach. This means that for IRB banks - which may be constrained by a standardized approach floor in the future - the application of the standardized approach to capital market driven transactions will result in a significant increase in business line capital requirements. We believe that the Basel Committee should consider a more risk-sensitive treatment which allows for a maturity adjustment to the risk weighting of fully-collateralized capital market driven transactions. This would increase the risk sensitivity of the proposals, reduce the gap between the standardized approach and the IRB approach, and reduce the risk of unintended consequences on the short term wholesale funding markets. In particular, we recommend that the Basel Committee give consideration to the impact on securities financing transactions due to their impact on the smooth functioning of the capital markets.

³¹ For further information in this area, please refer to the individual submission on the SA consultation by IACPM.

³² Basel Committee on Banking Supervision, *Basel II*, Para 321

Appendix 1

Large Corporate Impact

Rating (*)	Est. EAD Distribution	Est. % of EAD Externally Rated
AAA	1.0%	35.0%
AA+	2.1%	34.5%
AA	2.6%	34.0%
AA-	3.1%	33.5%
A+	3.9%	33.0%
A	7.3%	32.5%
A-	8.4%	32.0%
BBB+	11.1%	31.5%
BBB	12.7%	25.0%
BBB-	13.5%	18.5%
BB+	12.4%	12.0%
BB	9.6%	5.5%
BB-	6.6%	5.0%
B+	2.7%	4.5%
B	1.8%	4.0%
B-	0.6%	3.5%
CCC	0.3%	3.0%
CC	0.2%	2.5%
C	0.1%	2.0%

* internal equivalent of external rating

SME Impact

Rating (*)	Est. EAD Distribution	Est. % of EAD Externally Rated
AAA	0.2%	7.0%
AA+	0.4%	6.8%
AA	0.6%	6.5%
AA-	0.8%	6.3%
A+	1.7%	6.0%
A	2.9%	5.8%
A-	3.7%	1.0%
BBB+	6.6%	1.0%
BBB	7.1%	0.9%
BBB-	9.8%	0.9%
BB+	14.9%	0.8%
BB	15.5%	0.8%
BB-	17.2%	0.7%
B+	10.6%	0.7%
B	3.2%	0.6%
B-	2.3%	0.6%
CCC	1.1%	0.5%
CC	0.7%	0.5%
C	0.5%	0.4%

* internal equivalent of external rating

Appendix 2

Global Credit Data (“GCD”) has conducted a quantitative survey, in which 17 IIF member banks participated, to benchmark the BCBS proposed SA risk-weights.³³ The reference point for this analysis, based on GCD’s observation of historical PDs and LGDs, is the implied risk-weights under the A-IRB approach.³⁴

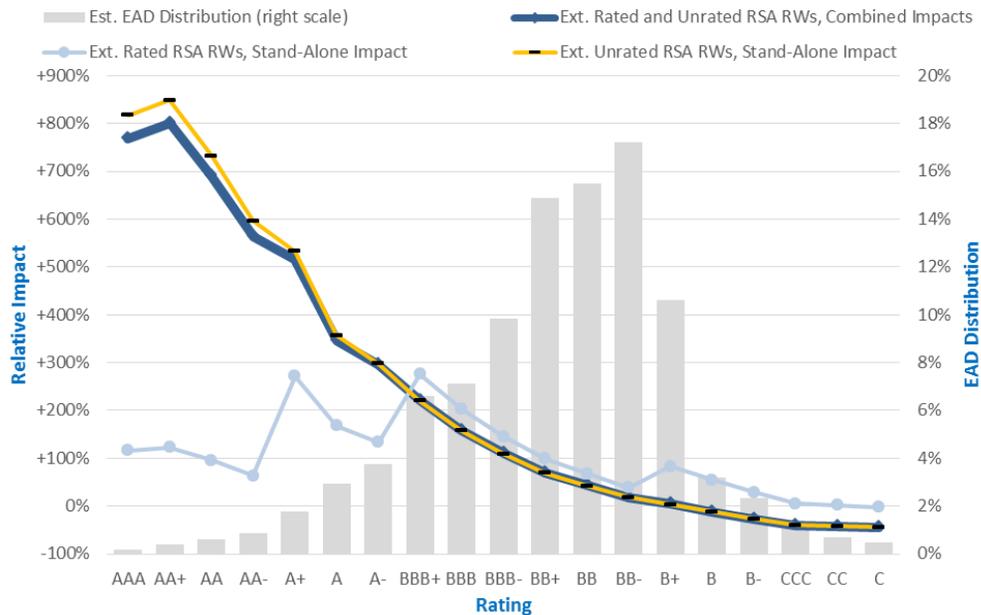
The following charts are a representation of the magnitude of the difference in RWAs calculated under the SA and A-IRB approach across the whole credit spectrum.

The curves represent the relative percentage increase in RWAs calculated under the SA compared to the RWAs calculated under the A-IRB approach *i.e.* 100% would represent a doubling of RWAs under the SA.

- i) The combined impact (*i.e.* the bold blue curve) represents the impact on a bank which is the aggregation of all participating banks. The other two curves represent the upper and lower boundaries of possible outcomes: Upper boundary (orange curve) - based on the SA risk-weightings when the exposure is not externally rated; and
- ii) Lower boundary (the light-blue curve) -based on the SA risk-weightings when the exposure is externally rated.

SME ECAI Allowed vs. Not-Allowed Jurisdictions

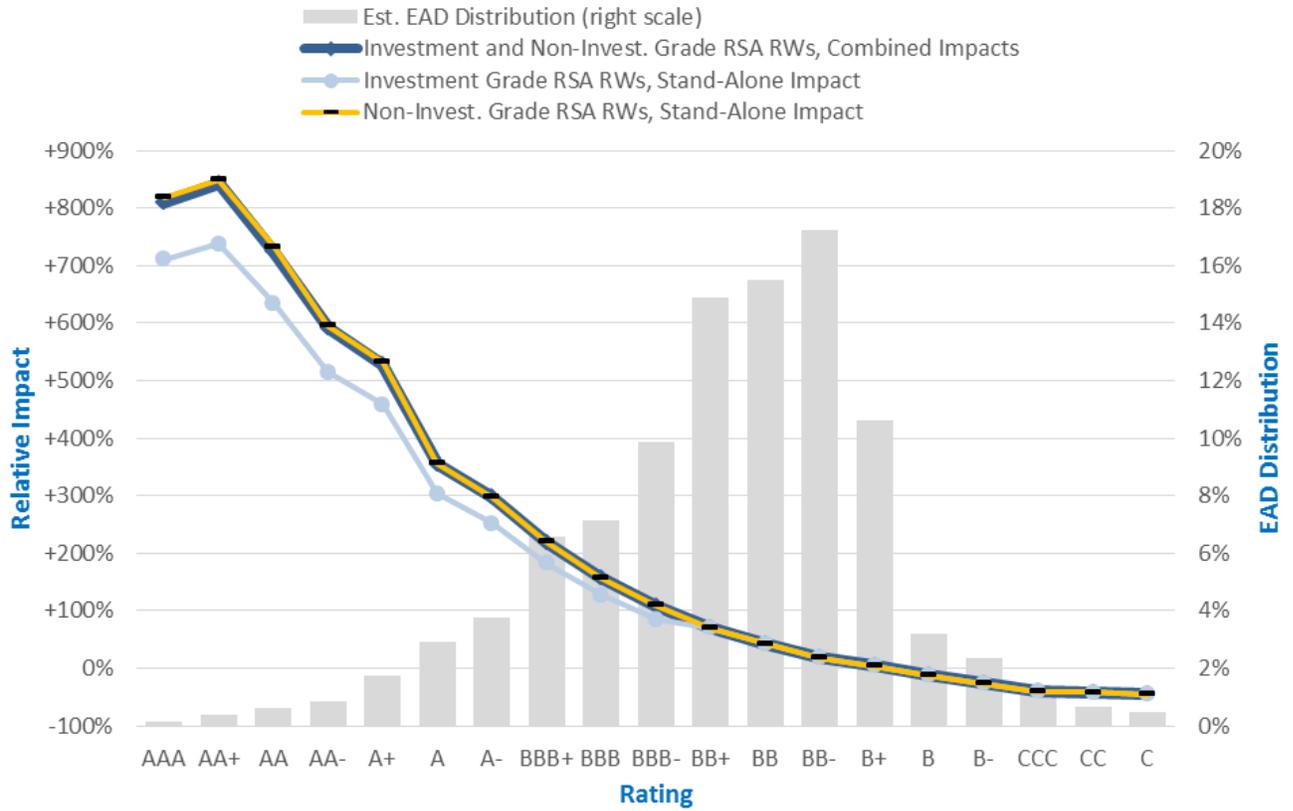
SME Chart 1 - Allowed



³³ Banks in the sample are based in Europe (8 banks), Asia Pacific (5 banks), North America (2 banks) and other regions (2 banks).

³⁴ PD inputs are based on GCD A-IRB curves and the LGD (38% for large corporates and 30% for SMEs) and maturity (2.5 years) inputs have been fixed.

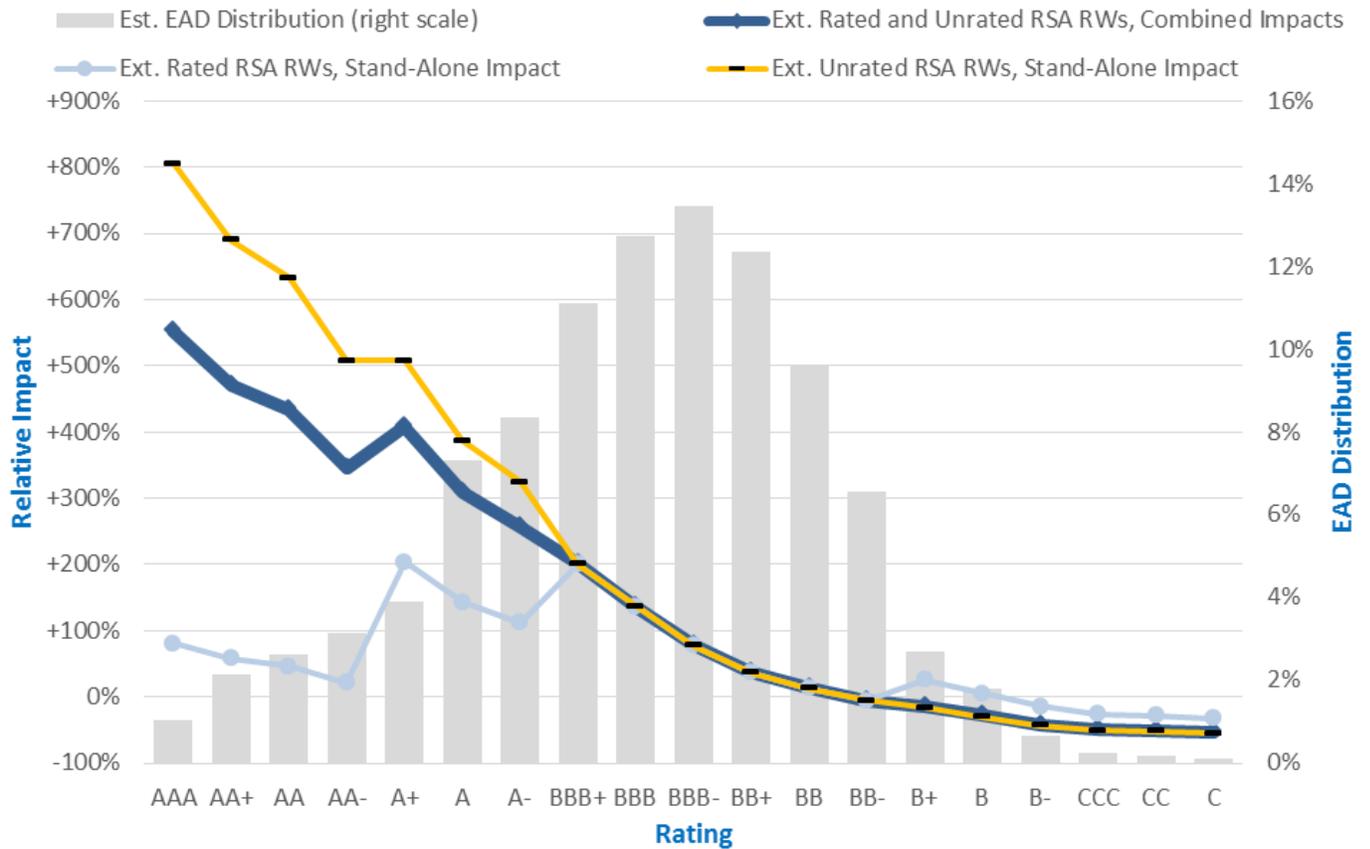
SME Chart 2 – Not Allowed



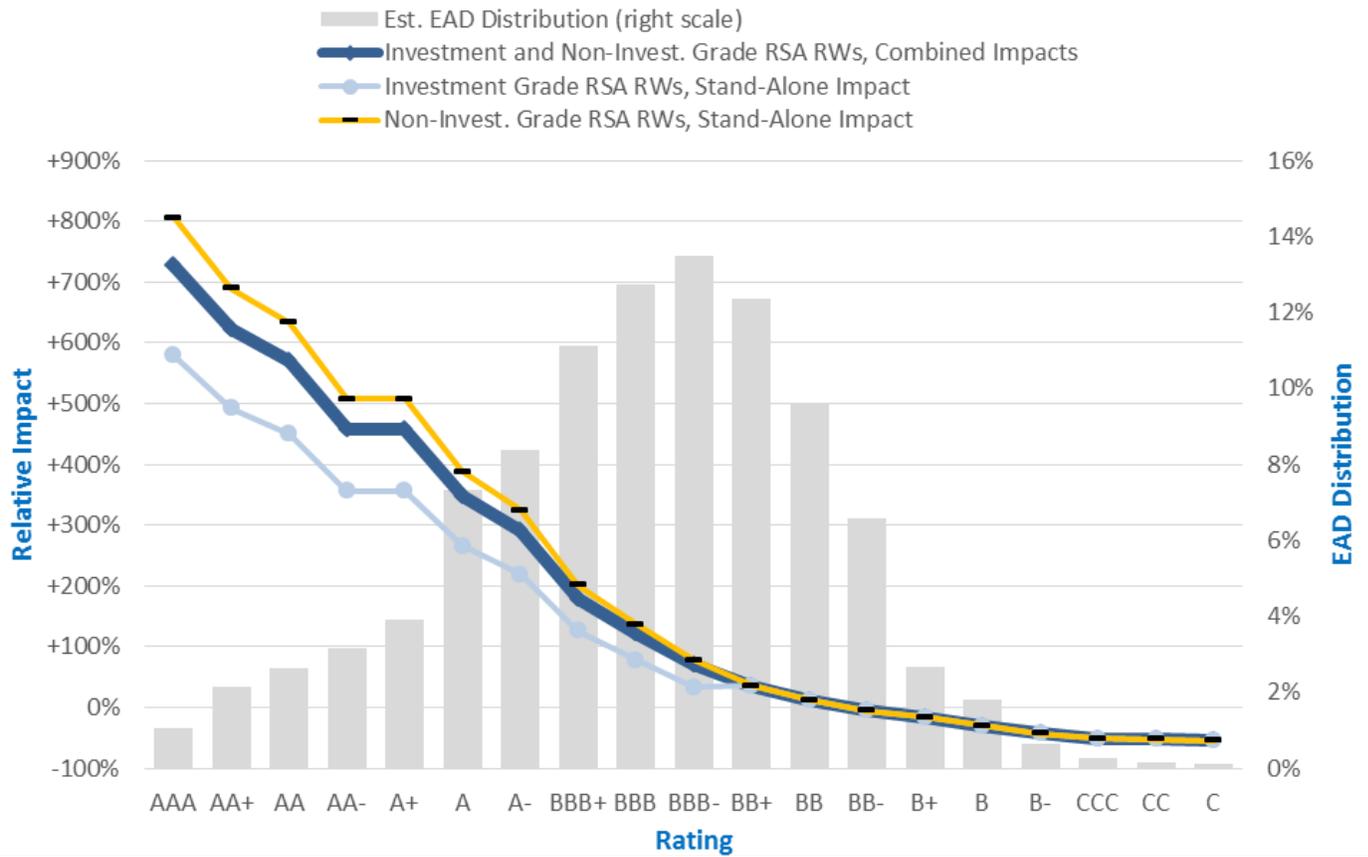
The percentage of SME exposures externally rated can significantly vary from jurisdiction to another (e.g., Central Bank Ratings of SMEs in certain jurisdictions). Therefore, the impact on top investment grade ratings can materially vary and create comparability issues globally.

Large Corporate ECAI Allowed vs. Not-Allowed Jurisdictions

Large Corporate Chart 1 – Allowed



Large Corporate Chart 2 – Not Allowed

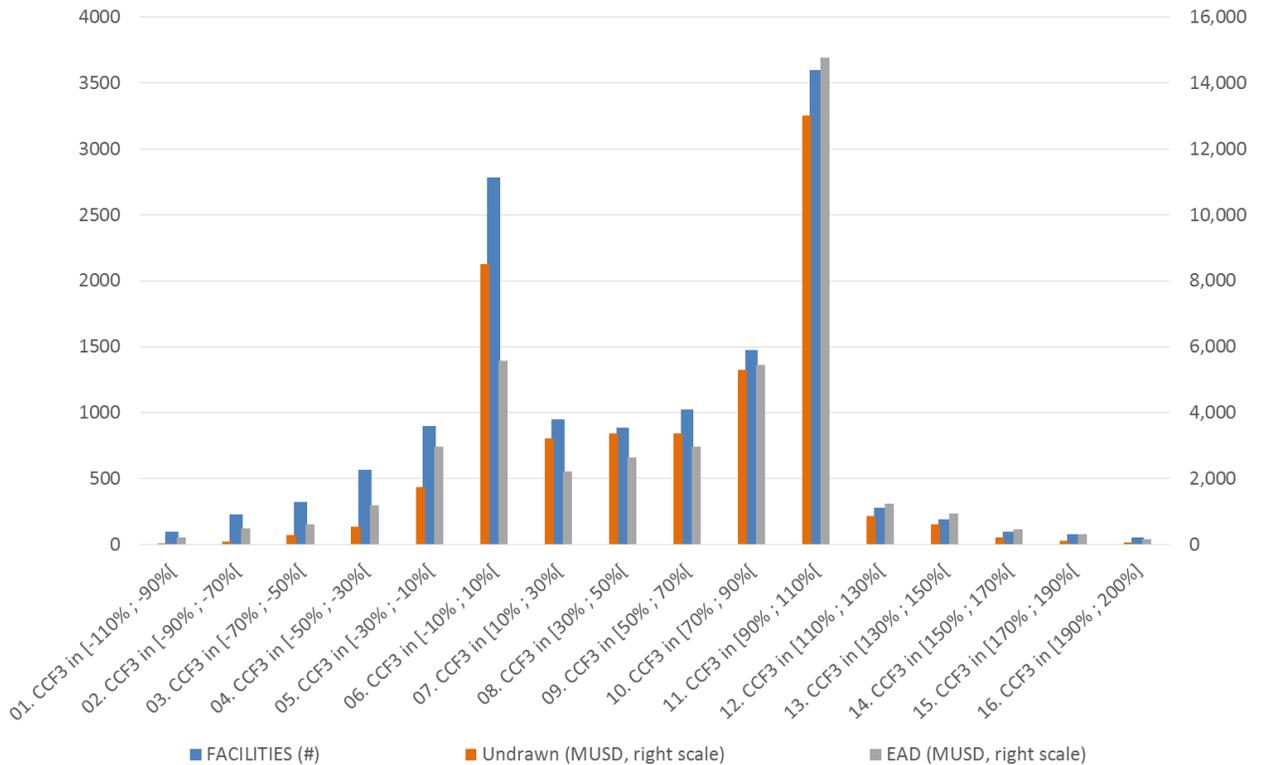


- See Bold Blue Curve
- Starting at c. +550% for 'Allowed' and c.+730% for 'Not-Allowed' Jurisdictions
- AAA to AA- impact is c.30% higher (relative difference) in 'Not-Allowed' Jurisdictions
- This is due to the 'Base' RW starting at 20% in 'Allowed' vs. 75% in 'Not-Allowed' Jurisdictions

Appendix 3

CCF3 Distribution and Filtering

Data Filter 2/2: CCF3 Floor and Cap



- Like LGD, CCF3 (overall) has a bimodal distribution: First mode equals 0% and the second mode equals 100%.
- Negative CCF3 means that the utilization has been reduced to a level below the level of one year prior to default (possibly by bank action and also by amortization).
- CCF3 of 0% is where utilization at default is the same at one year prior to default.
- CCF3 between 0% and 100% indicates a drawing up of the unused limit.
- CCF3 above 100% indicates utilization at default above the limit in place one year prior, which may come from a limit increase.