EACB Comments

Second consultative document

Revisions to the Standardised Approach for credit risk

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INTRODUCTORY REMARKS

The members of the EACB welcome the decision of the Committee to consult the industry a second time on a proposal for revisions to the Standardised Approach (SA) for credit risk.

We appreciate the improvements introduced especially with regard to the reintroduction of external ratings, treatment of bank exposures and SMEs. However, we still see the need for further work with regard to real estate, retail exposures, short term interbank positions. Moreover, we have serious concerns on the proposed treatment of equity holdings in companies in the non-financial sector. While in jurisdictions such as the EU these exposures are risk weighted at 100%, the Committee 250% risk weight (albeit reduced from the previous proposal of 300%) might strongly impair real economy financing. Equity holdings are, for many cooperative banks, also as an expression of a pivotal role in local economic development. We strongly oppose such requirement.

In this respect we would like to highlight the announcement made by the GHOS in January 2016 that the Committee will focus on not significantly increasing overall capital requirements.

The Quantitative Impact Study (QIS) published in February provides an essential opportunity to assess the potential impact of this regulatory initiative. It is therefore of the utmost importance that the new QIS results are shared with the industry. However, since the consultation and the QIS deadlines are not aligned, it is not possible for us to comment at all on the QIS results in this response. Therefore, we would ask the Committee to engage the industry even after the closing of the consultation period, when the latest QIS results are available, and to revisit certain key points made by respondents in light of the information derived from the impact assessment.

Moreover, at this moment in time, there is still uncertainty around the IRB framework and the calibration of the Capital Floors, and the future role of the SA in this context. It should be avoided that the SA framework becomes the predominant capital framework. For many (IRB) portfolios this would result in a significant loss of risk sensitivity, with the largest capital increasing impact for lower risk portfolios. This will in our view have serious negative impact on risk allocation and on system stability, as the best risks will be sold/shifted off balance and the relative higher risks (higher than observed in the SA) will remain on the balance sheet.

As an example, collateral is a very important risk mitigating element in lending to corporates. The extremely narrow approach taken in this respect effectively penalises sound business models such as Commodity Finance (or Project Finance), which are all important for the real economy.

We believe that a phase-out period should be provided on the basis of limiting the impact on current borrowers and providing banks enough time to adapt their lending conditions to the new rules.

GENERAL COMMENTS

The Members of EACB support the overarching direction of this second BCBS consultation, and in particular the effort of the Committee to take into account the views of respondents to the first consultative proposal by acknowledging the limitations of removing all references to external ratings. Their reintroduction as part of the risk determination for exposures to banks and corporates is welcome. Overall, compared to the first proposal, in this second revision of the standardised approach (SA) simplicity and risk sensitivity are better balanced. We strongly support the overall objective of not causing a substantial overall increase in the level of capital requirement. However, we believe that the calibration in the second CP will be very demanding in this respect. It will rather push up capital requirements for SA users, and given current discussions on capital floors widen the gap with capital requirements derived from IRB approaches.

Furthermore, we believe that differences in risk structures between jurisdictions and in application of credit conversion factors (CCFs) need to be better acknowledged. One area where national differences are very visible is in the housing market, with large differences in legislation, in tax, social system (especially insurances) which is also reflected in different products. Realistically this requires a structural change of these markets and changes in legal systems. That cannot be imposed, nor can it be taken for granted that governments would follow such directions. It involves e.g. harmonization of insolvency laws, making it easier ease to unwind and recapture assets and standardization of definitions of default.

While the BCBS designs, in principle, rules of the SA for internationally active banks, this standard will be relevant even for the smallest institutions. In fact, in many jurisdictions (e.g. in the EU) the rules will be directly applied to all institutions, with a 'one-size-fits-all' approach. Since the SA is almost the unique method for the calculation of capital requirements for smaller banks, it should be also assessed if the overall calibration of new requirements is unduly burdensome for them. As an example the combined effect of the:

- 50-75% CCF for non-retail commitments that are unconditionally cancellable at any time by bank without prior notice; and
- 0,2% hard binding quantitative granularity criterion provided for retail exposures;

might result in an unintended disadvantage especially for smaller banks.

The proposal on equity holdings could have a huge impact on the overall economy. Equity holdings have often been acquired several decades ago and usually are hold to safeguard added value, head offices and jobs in local regions. If the risk weights for these existing equity holdings are increased, thousands of jobs and dozens head offices in Europe would be endangered.

The Committee should also carefully evaluate the proposals in areas where they could lead to materially increased capital requirements. According to the 2014 QIS results, capital requirements under the indicative risk weights presented in the original consultation paper would increase substantially relative to the current SA and IRB. It was clearly stated in the 2014 consultation (and is reiterated in the current consultation), that increasing capital requirements was not an objective of the revised framework, we are grateful revisions were undertaken accordingly in this iteration. However, we note that in some areas (particularly for off-balance sheet instruments, low risk residential mortgages in specific jurisdictions and some corporates asset classes), capital requirements will increase under the current proposals in way that could detrimentally impact a bank's ability to lend under certain products. We also would like to request more detailed impact studies of proposals on the economy as a whole. In this regard, the industry supports the upcoming Basel monitoring exercise that will include a QIS on the credit risk SA.

With regard to the due diligence process, it is stated that the analysis performed cannot ever result in lower risk weights that the ones assigned as 'base' risk weights with the external ratings. This provision basically disincentives any risk management effort made by banks to carry out an objective and accurate analysis. Indeed, institutions might actually have disincentives to perform the assessment on a best effort basis. Moreover, it could be operationally burdensome, especially for smaller banks, and even lead to the opposite result in terms of comparability: in lack of objective and clear criteria, the results could be hardly comparable, jeopardizing the desired level playing field. For these reasons we deem that with reference to due diligence more objective criteria and clarification should be provided via guidelines, for instance. In addition, we note that, based on the proposed RW tables, potential revisions of the RW buckets due to due diligence activity would likely be driven almost exclusively by diverging views on whether the counterpart is Investment Grade or not and how to consider government support (especially in higher rated countries). From this perspective due diligence could be defined as to incorporate explicitly the assessment of these two factors.

Finally, we appreciate the inclusion in the consultative document of the statement that "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 in the implementation timeline the processes that each jurisdiction has to go through to transpose international standards to local rules.

SPECIFIC ISSUES

1. Residential real estate

Overall, we find the second CP a substantial improvement on the first CP, but relevant problems still need to be addressed. Excessive RWs, combined with adverse features such as the insistence on retention of LTV at origination and the loss of tranching/loan splitting, seem to point towards a rather sharp rise of capital requirements in the residential real estate area.

We believe that the Committee's proposal regarding real estate as an exposure class does not take into account important jurisdictional differences globally. This is particularly relevant when combined with the Committee's work on a potential floor for the IRB approach, as this will ultimately lead to different effects in different countries. Actual losses, future risks and adequate capitalisation should be the basis. Deploying only the LTV is no good reflection of risk if not seen in relation to the relevant housing market.

In addition, some of the rules on the calculation of the LTV and the recognition of collateral have very asymmetric effects on individual jurisdictions. For example, the LTV calculation cannot be adjusted if the loan is not amortising, as 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 (which cannot be touched other than to repay the loan at maturity). This is largely driven by the tax laws in the country in question. The proposed treatment discriminates against mortgages in these countries as these are classified as high risk (high LTV), while the effective LTV (and the actual real estate exposure) are reducing through the accumulated savings.

Calculation of LTV

According to the proposal, institutions should be using the original property value measured at the time of loan origination. In our opinion, LTVs should be calculated on the basis of the current debt outstanding as well as the current property value. However, the original valuation may create perverse incentives where the borrower is considering refinancing. For the same loan (monetary amount) and the same property, the risk weighting applied by a new lender could be lower if there has been an increase in property value since the original loan was made, as the new lender will use the latest valuation, while the original lender cannot. The risk, of course, is the same. Thus, this feature incentivises the unnecessary churning of mortgages, i.e. the opposite of "originate to hold". The present proposal creates an incentive to change lenders, as customers would be able to obtain a lower risk weighting as prices increase.

We therefore believe that institutions should be allowed to monitor the value of the collateral, and also to recalculate the LTV according to the outstanding loan amount. We would thus propose to include an annual intrinsic value adjustments as this is in line with current risk management and underlying risk. Footnote 43 should thus allow upwards adjustment to the value of the property as well. We would also propose to include a inflation adjustment or the development of the house price index in the value of the collateral.

We welcome the slightly lower risk weights in the individual LTV buckets compared with the first consultative document. However, this is not sufficient, and the proposal should provide for higher granularity and more buckets.

For example, exposures could be classified as Grade A, B or C as suggested for banks. It should be possible to assign lower risk weights to institutions in countries/areas where recorded losses are demonstrably low than to institutions with high losses. Therefore, the granularity of the risk weighting should be further increased according to the loss records of the institutions.

There is nothing to prevent different risk weightings across national borders based on actual losses and structural differences between countries (systems of forced sale, pension assets, etc). Indeed, that would increase the comparability of risks across countries/areas/systems.

Particularly in view of the higher RWs for high LTV lending, there needs to be better recognition of mortgage insurance as credit risk mitigation. While there might be more opportunity for mortgage insurance to reduce the RW on high LTV loans, the route is very complicated, and we see that there is also a lack of clarity of the proposal in this respect (as well as an unfair discrepancy between the standardised and IRB approaches).

It is still unclear why the Basel Committee plans under certain conditions to assign higher risk weights to exposures which are secured by an immovable property than to usual retail or corporate exposures. If higher risk weights are applied to exposures secured by immovable properties than exposures without these securities the incentive to use these securities will not be very strong.

For instance, in the EU (see Art. 124(2) CRR) supervisors already have the possibility to raise the present risk weights, if the loss experience of exposures secured by immovable property and the forward looking immovable property markets developments make this supervisory measure necessary. On that ground, we see no need for tightening further the base risk weights.

With regard to the proposals for "materially dependent" loans in paragraph 56, There is a concern about "interest-only" loans, i.e. where the borrower only makes interest payments (out of other income) for the duration of the mortgage and then refinances the entire principal or repays it from the sale proceeds as appropriate. On a strict reading of paragraph 56, this type of loan would have to be treated as "materially dependent" as the wording refers specifically to repayment – i.e. of principal – rather than just payment. We understand that this is only an unintended consequence of the choice of words, i.e. not deliberate policy choice, however we remain concerned and would welcome a clearer formulation.

Buy to let

We have serious concerns with regard to the treatment of the "buy to let" exposures, i.e. lending to individuals who borrow to buy a second or third property which is rented out and where the rental income is calculated to cover the mortgage interest and some repayment is an attractive sideline for quite a lot of banks. The first question is, whether it falls under the "materially dependent" category. In some cases the borrowers are high earners. They calculate to have some rental income (which is very realistic especially when banks are building pools of flats organizing the rental agreements and thus covering the risk, that there might be phases, in which some single flats are not rented out). But the repayment by these borrowers is not really depending on the rental income.

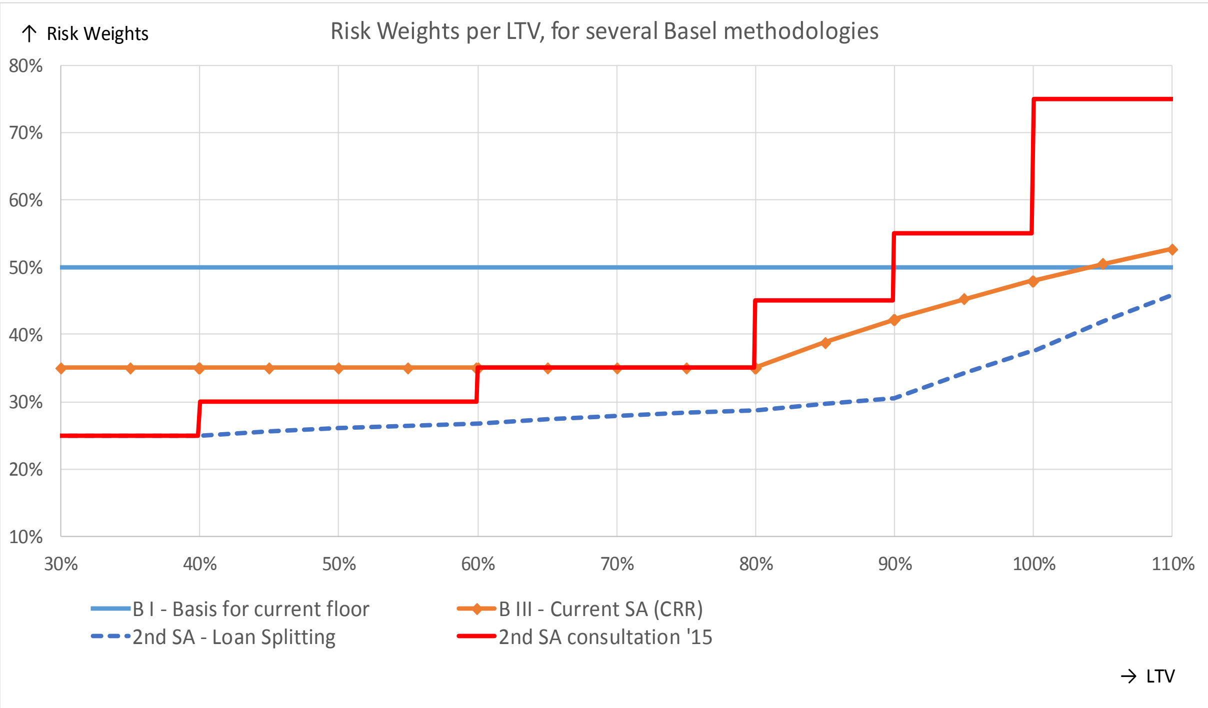
Even if the repayment is depending on the rental income, the extent to which the proposed RWs are higher is out of proportion with any realistic difference in risk. Many of our members' actual loss experience is that "buy to let" is no, or only slightly, riskier than their main owner occupied book. Certainly their evidence challenges for instance the 60% < LTV < 80% bucket where the "materially dependent" category has an RW of 90%, even higher than the RW of 75% for retail unsecured exposures, while owner occupied gets 35%.

Finally, there is a question about how far it is sensible to apply the new RWs retrospectively to existing mortgages. Given the fairly rapid turnover of mortgage books, it would be more sensible to apply the new RWs only to new loans advanced after the date of finalisation of the Basel rules, and not require reallocation of older loans. This would have the effect of a more gradual transition to the new RWs, without affecting the end-point.

Use and benefits of the "Loan splitting" practice

According to the second CP the entire exposure is placed in a risk weight bucket corresponding to the total LTV. "*If a bank grants different loans secured by the same property and they are sequential in ranking order (ie there is no intermediate lien from another bank), the different loans should even be considered as a single exposure for risk-weighting purposes, and the amount of the loans should be added to calculate the LTV ratio.*" (see footnote 44).

This proposal would clearly impair the use of loan splitting (i.e. "tranching" of the loan) which is widely practised across the EU (and other jurisdictions) and regulated under CRR and its previous legislative frameworks. This departs from the incremental risk view, practised by way of loan splitting or tranching, across the European Union under the CRR, and elsewhere (e.g. Switzerland and South Africa). Moving away from this accepted practice creates both sharp "cliff effects" at the boundary LTVs, as illustrated in the graph here below.



The proposed approach would also create perverse incentives to supplement a main mortgage loan with top-up high-cost credit. A borrower who needs 82% LTV may find that his SA lender has to increase the mortgage rate considerably if the loan exceeds 80% LTV even marginally, so will take only a 80% LTV loan and look to borrow the rest elsewhere, typically a small top up loan at high cost. Overall that borrower is slightly weakened, and the first lender faces slightly greater risk, to no obvious advantage.

In fact the possibility that the client would take a second loan from an institution to cover for the additional portion is constrained by the documentation requirement and credit process that would have to be replicated. Ultimately the costs for the customers would be much higher.

Whereas tranching (even with fewer RW buckets) generates a smooth and sensible correlation between LTV and RW, avoiding jerky cliff effects and captures the true risk better.

The risk weight of an exposure with residential real estate collateral may, according to Art 124 CRR, be applied to any exposure or any part of an exposure that is "fully secured" by residential immovable property. Therefore it is allowed to split an exposure in a fully secured part and in a non-secured part. The part fully secured by residential real estate receives (if other conditions are fulfilled) a risk weight of 35 % and the non-secured part receives a risk weight according to the counterparty (e.g. 75 % when falling in the retail exposure class).

Summarising the proposed ban on this approach of loan tranching or splitting would have numerous and serious consequences on risk management and real estate markets:

- It creates sharp discontinuities at the high LTV end (see tables 9 to 12).
- It produces perverse incentives: for example, a borrower in need of a loan of 81% LTV overall – will be better off, if he keeps the main mortgage loan to exactly 80% and takes a top up loan from a high cost lender, for the small additional amount. This disguises the true risk.
- The consideration of different loans as only one loan (footnote 44) exacerbates this problem. It is a common and sound practice for banks to require that each mortgage does not only secure the actual loan exposure but all future exposures whatever reason they may have (debts on current accounts, future car loan, etc). This prudent common practice helps keeping the LGDs of future exposures low when the original exposure is partly repaid and there is some value of the real estate left over to cover the other loans ranking equally. The rule in footnote 44 gives an adverse incentive. The risk weight of the original loan would be lower (in case of cliff effects may be much lower) when the bank is less diligent with regard to securing future exposures. We do not believe that for supervisors this would be the intended effect.
- The proposed departure of loan tranching is also in contradiction with the principle laid down in Para. 104 of the second CP: "*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.*" Considering the logic of this principle, this should also be valid when a CRM technique (real estate collateral) leads to a qualification as a separate exposure class in the SA.

We are in favour of tranching as this better aligns with the underlying risk. Furthermore, this prevent the negatives of the current cliff effect of current LTV buckets.

Loan to income/fixed interest rate business model

It has to be reminded that there are different recognised business models for residential real estate loans. In addition to the "Loan-to-value/variable rate" model there is "Loan-to-Income/fixed rate" (particularly in France, but also in Japan). The Committee's proposal would have vast and negative impacts on the housing markets where the LTI model prevails. In these cases, an alternative policy option (e.g. calibration based on internal LTV bucketing) should be explored and allowed to avoid disruptions on the credit provision and the housing market.

The LTI model is based on 3 principles:

- The loan has a fixed rate, monthly payments are predetermined taking into account the loan amortization plan.
- The credit decision is taken based on the ability of the customer to repay the loan.
- The loan-to-value, i.e. the property value, is considered to determine the amount of the cash portion of the loan that must be paid in to be granted the credit.

At the same time institutions have developed very sophisticated ALM in place to monitor risks involved. The granting of credit occurs only if the client has sufficient income: in principle repayment of the loan cannot exceed 30% of its income calculated after tax. The focus is primarily on the client's capacity to repay the loan and not on the value of the property used as collateral (LGD). This, in addition to the obligations to subscribe death and disability insurances, leads to very low default rates. Indeed, the gross non-performing loan (NPL) ratio for housing loans in France was between 0.89% and 1.45% from 2001 to 2013.

In this context, the customer is not exposed to changes in the exposure/risk due to market fluctuations. Rate increases do not affect the borrower and a rate decrease favours a renegotiation of the loan rate or the repayment at a very low penalty. This has beneficial effects on the creditworthiness of the borrower. In general, the customer has also the possibility to choose a floating rate credit with cap and/or floor, but this alternative is rarely used. In 2014, fixed rate loans represented 92.0% of new home loans in France[1].

The current proposal would be extremely penalizing for this model despite its stability, and would entail massive efforts to illustrate the change of paradigm to customers with no assurance that it will be understood. Institutions may adapt and move to the LTV model, but this may lead to an increase in default rates. Banks would face a double constraint, at least on their stock of loans that amortizes very slowly: an RWA exogenous to risks assumed and managed, and excessive risk weighted assets. The calibration would be performed on the basis of the LTV model, with customers presenting higher risk profiles: this would at least partially result in an increase in interest rates over the next

[1] "The housing finance in 2014" (ACPR).

15 years. This will also be incorporated in the capital requirement resulting in an undue and widely penalizing risk weighted assets for "LTI/fixed rate" banks.

We would propose as an alternative approach, to envisage LTI as a sort of external ratings for housing. In practice there would be two policy choices: either the regulator/supervisor recognizes the concept of LTV as the key factor of the business models for its jurisdiction or it does not. In the latter case, the BCBS framework should authorize the use of internal weights based on strict and predefined internal valuation criteria and define more appropriate RWAs according to the performance of business models, the bank and the choice of its customers.

At the very least, for the calibration of risk weights based on LTI, the weight of the risk for floating rate loans based on LTV should be adjusted by cancelling the off-balance sheet exposure clients face because of their interest rate position between revenues and payments: according to the initial method, the EAD generated by a 20 years swap would be around 20% of the loan exposure, therefore the risk weight for a fixed rate loan should be 20% lower than a variable rate loan. Such approach is similar to the add-on approach for the risk weight of loan whose currency is different from the revenue of the client.

More importantly, this proposal has the advantage not to touch the standard obtained by the Task Force on LTV: indeed with standard methods on banks and corporate, the Task Force opened the way for the possibility of alternative policy options.

Add-on for currency mismatch

Add-on risk weight to certain exposures with currency mismatch. The proposed 50 % risk weight add-on to unhedged exposures with currency mismatch is inappropriate because such kind of credit risk is already included in an external rating. Thus the risk weight add-on to unhedged exposures with currency mismatch would lead to a double counting of risks.

It does not seem appropriate to apply the same add-on without differentiation between solid borrowers with low risk weight and weak ones with high risk weight. Solid borrowers will be much more able to cover currency risk than weak borrowers. Therefore the currency mismatch add-on shall take into consideration the original risk weights of the respective borrower. The flat, general risk weight add-on for exposures with a currency mismatch should be deleted or made subject to the default risk of the borrower.

Commercial Real Estate

Commercial real estate exposures are strongly penalized by the treatment proposed by the BCBS. There is a poor recognition of the mortgage-enhanced security. Real estate secured exposures appear to be treated as a separate asset class. Indeed commercial real estate exposures with a LTV over 80% receive a higher risk weight than unrated (unsecured) corporates exposures. Unless there is consistency between risk weights across different exposure classes, lenders may be incentivised to not request any collateral at all. The risk weight tables for commercial real estate exposures should be more granular, with lower risk weights for LTV < 60%.

It is important to highlight that commercial properties represent important credit risk mitigation instruments for firms, especially SMEs.

Therefore, we propose to maintain the current risk weights for commercial real estate exposures, at least in those cases where repayment is not materially dependent on cash flows generated by property.

Land acquisition, development and construction (ADC) exposures

According to the new treatment these kind of exposures are classified with the same risk weight as "defaulted exposures". The unintended consequences of this proposal could be a reduction of the bank capability to grant these loans, with a general increase in interest rates affecting borrowers. We propose an important reduction of RW, classifying the exposure according to the nature of borrower, even if the mortgage is not recognised as eligible credit risk mitigation. Furthermore, small scale home builders deserve a distinct treatment as the risk profile is significantly lower than that of speculative building development.

Additional issues

We would like to stress that bullet mortgages should be weighted in line with table 9 as the intention of this type of residential real estate financing and the repayment is 'not materially dependent is on cash flows generated by property'.

We also have concerns with regard to the possible interaction with IFRS 9. Over a similar period, IFRS 9 will mean (almost certainly) higher provisions using an expected rather than incurred impairment /loss approach. At the same time the Committee is increasing RWs for various loan categories on the basis that they are higher risk. We think there is almost certainly an element of double counting here, as the two initiatives are being pursued quite separately.

The finished property criterion in paragraph 50 also applies to commercial real estate as paragraphs 58 and 60 also refer to paragraph 50. In this context the finished property requirement may be counterproductive as real estate being a non-essential business asset often is vacant while serving best for credit risk management purposes; the requirement may also cause problems with forest or agricultural land. Therefore it should be clarified that finishing is only required where an object is under construction but not where no construction is planned at all.

So called equity release credit agreements (see Art. 3(2)(a) directive 2014/17/EU on credit agreements for consumers relating to residential immovable property and amending) where the creditor: (i) contributes a lump sum, periodic payments or other forms of credit disbursement in return for a sum deriving from the future sale of a residential immovable property or a right relating to residential immovable property; and

(ii) will not seek repayment of the credit until the occurrence of one or more specified life events of the consumer, as defined by Member States, unless the consumer breaches his contractual obligations which allows the creditor to terminate the credit agreement should not automatically receive a risk weight of 150 % but rather a risk weight according to table 10 of the consultative document (70 – 120 % depending on the LTV).

2. *Equity exposures*

Under the CRR equity exposures in banks and companies in the non-financial sector shall be assigned a risk weight of 100%. In the view of the Committee these equity exposures should have a risk weighting of 250%. Although the Committee has decreased the percentage from 300% to 250% the envisaged treatment is still neither justified nor understandable. The increase of these risk weights will lead to sales of equity holdings by credit institutions. The Basel Committee has to pose itself the question if it acts in line with the demand not to impair the financing of the real economy. The Committee has to bear in mind that according to these proposals the existence of several jobs in enterprises where banks have equity holdings are endangered.

Many institutions have broad and well-diversified investment portfolios and see equity holdings also as an expression of their role and responsibility for the economic development of their region. Banks may hold participations in enterprises of different industrial sectors, e.g. enterprises and industrial holdings in the areas of construction, medias and agricultural companies (including diaries, mills and the processing sector). These holdings have often been acquired several decades ago and are of high interests for the overall economy as they are not hold for profit purposes only but rather to safeguard added value, head offices and jobs in local regions.

Particularly in current economic environment equity holdings are an additional funding source for the real economy. Differently from the strategy of investment and hedge funds, enterprises are satisfied to have a reliable partner for several decades. From this perspective long-time-intended equity holdings should rather be promoted than penalised, to support own fund and long term financing of enterprises (in this context the Commission is taking numerous initiatives in the EU).

The Committee does not explain why the risk weights for these exposures need to be increased. In the consultative document it is only indicated that the standardized approach shall be aligned to the IRB approach. However these approaches have completely different objectives. This issue has a prominent importance in certain jurisdictions while in others it would not present similar challenges, both in terms of implementation and overall spike in capital requirements and in terms of impact for the real economy. Moreover one has to consider that the users of the SA are in general obliged to use more conservative risk weights than IRB users. Through the increase of risk weights for participations this disadvantage for mainly smaller and medium sized banks would be further increased.

Furthermore especially the banking industry is the world’s most regulated and supervised economic sector. Especially in times of a low interest rate policy by Central banks investments in enterprises provide a secure source of financing beside the traditional bank business. The same applies to equity exposures in companies outside the financial sector. Stock companies, for instance, are controlled by the supervisory board and the shareholders in the annual shareholder's meeting by the use of participation and appealing rights. Moreover most European Stock Exchange Laws contain draconian penalties in case of the violation of transparency requirements and comprehensive supervisory powers of the exchange supervisory authority.

Also supervisors are questioning the business model of banks and are encouraging them to find new revenue sources within pillar 2 requirements (SREP-process in Europe). However, also for other legal forms of enterprises increasing risk weights aren't justified at all. Against the background of the current business environment it is essential that the risk weights for existing equity exposures remain at their current level (as provided in the EU under the CRR for instance). The same approach should be applied in the case of well-diversified portfolios of equity investments. Otherwise unintended damage to the economy will be caused.

3. ***Exposures to banks***

We welcome the fact that the new proposal returns to the use of external ratings. However the Committee requests that credit institutions have to perform a due diligence test to ensure that the external ratings appropriately reflect the creditworthiness of the bank counterparties. "Due diligence" might be the wrong definition for what is envisaged in the second CP. The overall process is hardly described, the vague indications leave too much room for interpretations and do not allow to understand regulators' and supervisory expectations. The requirements, particularly for smaller institutions, should be reasonable and clear to implement. After all, the ratings for institutions have not revealed weaknesses in the past.

Moreover, where standardised institutions have access to external credit ratings and at least the summary of the analysis lying behind the final ECRA (External Credit Risk Assessment Approach), it cannot be efficient for such typically smaller and less well-resourced institutions to re-perform such analysis for themselves. Nor should the due diligence concept introduce new obligations that overlap with existing well-established credit control practices. We invite the BCBS to take a sensible, practical position in response.

One of the main assets of the standardized approach is that credit institutions do not have to execute lengthy assessments of every single counterparty but may rely on external ratings. To name it more precisely it is against the spirit of the standardized approach to assess the financial performance of each counterparty by a due diligence test. We believe that the proposed due diligence should rather be modelled around existing practices in institutions. The due diligence requirement would force non-IRB banks to assess validity of external rating to internal rating, which they have not been required to do, and would be excessively burdensome in the implementation, especially for small banks. Proportionality should be considered in the framework.

Furthermore the due-diligence approach is not implemented consistently. The CP proposes to require banks the application of higher risk weights if the due diligence test leads to a higher risk weight than the one based on the external rating t. However, if the due diligence test leads to a lower risk weight than the risk weight based on the external rating, the credit institution would still be obliged to apply the higher risk weight. This approach does not seem to be balanced.

Lastly, introducing due diligence requirement to the RW bucket classification might cause wider RWA variance among banks. The appropriateness of the use of external ratings is warranted by a clear linkage between the external ratings and the credit risk mapping. By introducing due diligence requirement to give effect to RW outcome, the differences of methodologies and capabilities of credit assessment among banks would cause wider RWA variance.

Exclusion of government support from external ratings

We also question the criterion that the external ratings must not incorporate assumptions of implicit government support. The Committee itself is obviously aware of the fact that bank ratings without government support are not available at the moment, and results will depend on the willingness of rating agencies to adapt. We ask the Basel Committee to reconsider this criterion.

Cliff-effect between rating buckets

The proposed risk weight table needs to have granular bucketing. The current proposal for ECRA approach suggests "Base" risk weight of 20% for AAA to AA-, but A+ to A- and BBB+ to BBB- both being 50%, followed by 100% for BB+ to B- and 150% below B-. A drop of one notch from A- receiving a double RW is causing a cliff effect, and the current proposal is highly risk insensitive, which is contrary to the BCBS' purpose of balancing risk sensitivity and complexity of the standardised framework.

Standardised credit risk assessment approach (SCRA)

As external ratings are not available for all banks and the use of external ratings may be expensive and smaller banks often will not make business with many externally rated banks, all banks should have the choice whether or not to nominate an external credit assessment institution (ECAI) for this class of exposure, even when a jurisdiction generally allows the use of external ratings for regulatory purposes. *In particular, when in this case risk weight buckets apply, there should be a fourth bucket with a risk weight of 20%*.

We are not convinced to introduce further disclosure requirements. The considerations on further disclosing requirements show that the new proposal with due diligence processes is not an adequate way for a review of the SA. The comparability of capital requirements is most suitable with the current SA. SA banks are already subject to disclosure obligations from various different sources, including existing Pillar 3, which in aggregate are both burdensome, and even counter-productive, as the sheer volume of disclosures reduces the salience of the most important items. Nor are the detail of such disclosures generally of interest to the larger public. In short, there is already disclosure overload and any additional one is not needed. A practical question also remains under the SCRA as to whether, and how frequently, the Grade A/B/C of the institution is to be disclosed (by the institution itself) or whether this status is to be determined and periodically updated by each (standardised) counterparty from the institution's underlying Pillar 3 or other disclosures. In this respect the second CP is very unclear.

Furthermore, the proposal requires a minimum risk weight of 150% if any of the published and binding minimum regulatory requirements determined by its national supervisor is breached (paragraph 27).

We appreciate that footnote 35 clarifies that liquidity requirements in this context are not considered "binding". To secure the countercyclical capacity of capital buffers it should also be made clear, that the combined buffer requirement is not considered binding and that a SREP-Ratio is not published.

Otherwise, such rule, which could from one moment to the other lead to an increase of the relevant capital requirements, may trigger dangerous chain reactions: e.g. in case of a breach of buffer requirements the resulting 150% risk weight could amplify the crisis, and trigger a negative spiral with a concrete risk of pro-cyclicality that would bring no benefit in risk appreciation. The chain effects on funding costs should be properly considered in final calibration.

Specific aspects for cooperative banks' intra-group/network exposures

Despite a revision to the risk weighting method for bank exposures, current frameworks for applying a fixed risk weight should be able to be maintained. This should include cooperative banking network where local member banks hold deposits in a central institution and do not engage in risky trading and investments as the central institution manages the entire intra-group liquidity, and an institutional protection scheme (IPS) is established as their own safety net to safeguard their solvency where necessary. In such case, carving out a single bank from its group/network and assign independent variable RW ignores the critical liquidity and credit support from the entire system. The recognition of these elements is particularly important especially when local banks of cooperative groups/networks have a legal obligation to maintain funding at the level of their central institution. This is not only the case in Europe but also in other jurisdictions.

In the case of Japanese agricultural cooperative bank, which is composed of three tiers municipal banks, prefectural banks and the national/central bank, municipal banks are obliged to place two-thirds of the surplus funds into the upper prefectural banks and prefectural banks owe obligation to place a half of the surplus funds into the upper national bank by statutes.

Financial support is granted, if necessary, by way of injecting necessary funds drawn from the own safety net funds almost equivalent to IPS in Europe, which enables the participants in the system to safeguard their solvency.

The above examples illustrate the different nature of exposures within a cooperative group/network from other general bank exposures. Such difference is well recognised, fo instance, under the current CRR in the EU, that allows recognition of a 0% RW for intragroup or intra-IPS exposures that meet certain conditions. The BCBS should already be aware of the existence of such treatments, and we appreciate that some aspects have been recognised in its regulatory framework e.g. in the LCR, NSFR, TLAC requirements, given the uniqueness, stability and robustness of cooperative groups/networks[2].

Short term bank exposures

The BCBS should allow the practical definition of the short-term interbank market being up to one year, instead of the proposed definition of the original maturity of three months. The CP indicates that the reason for the introduction of short term bank exposure criterion is to avoid negative impact on market liquidity in the interbank markets and interference with monetary policy channels. This means that the risk weight difference between short term and non-short term does not stem from changes in credit over different tenors (and it is also apparent from the implication of the proposal, for instance, that four-month and 30-year maturity have the same risk weight).

We understand that this is the BCBS' effort to need to balance simplicity of the framework and maintain financial stability, but creating the three-months threshold within the short term interbank market does not seem to help the BCBS' intent.

We imagine that the Committee's initial natural thought was rather to define short term as a maturity below one year, as stated in paragraph 29[3], and we agree with such definition from the industry's perspective, because it aligns with the general practice of interbank short-term market; in most countries it's money market instruments up to one-year maturity.

Also, thinking of market liquidity impact, the BCBS should consider the market dynamics that will be caused by other ongoing regulatory reforms including NSFR and TLAC that would incentivise banks to secure longer maturity (typically beyond one year) funding, thus banks' funding preference would shift beyond three months and the market dynamics may change from what the BCBS analysed so far.

We would also propose that the maturity should be computed as residual maturity instead of original; this option does not add much complexity and it makes the assessment more accurate.

Finally, setting the bar at three months in this framework would not only penalize banks (both those that offer and those that receive exposures through the cost transfer of

[2] See BCBS, *Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools*, January 2013, ¶105, available at http://www.bis.org/publ/bcbs238.pdf, BCBS, *Basel III: the net stable funding ratio*, October 2014, ¶25 footnote 10, available at http://www.bis.org/bcbs/publ/d295.pdf, and the Financial Stability Board, *Total Loss-absorbing Capacity (TLAC) Term Sheet*, November 2015, page 12, available at http://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf

[3] CP, page 30. "The sovereign floor will not apply to **short-term (i.e. with a maturity below one year)**[emphasis added], self-liquidating, trade-related contingent items that arise from the movement of goods."

incremental risk weight to certain extent), but also reveal potentially problematic from the perspective of monetary policy operations. For example, while NSFR and TLAC would incentivize the market to move to closer or beyond one year term, the current CP proposal would incentivize the market to move to three months or below; this may result in skewing market pricing and market liquidity of four-months to one-year term zone, which is important information for appropriate monetary policy communication between central banks and market participants for the monetary policy stance. It also needs to be mentioned the impact to economy through other inter-linked markets, including contracts with corporates using LIBOR and other interbank market-based indicators.

4. ***Exposures to corporates***

Regarding exposures to corporates the Basle Committee proposes a due diligence for each counterparty. This approach is not in line with the spirit of the SA and jeopardizes the value of an external rating (see above exposures to banks). Furthermore the provisions for SME financing need to consider the special situation of SME-financing in Europe. Paragraph 37 reads as follows:

"For unrated exposures to corporate SMEs (defined as corporate exposures where the reported sales for the consolidated group of which the firm is a part is less than €50 million), an 85% risk weight will be applied. Exposures to SMEs that comply with paragraph [46] will be treated as regulatory retail SME exposures."

This provision is on the one hand to be welcomed because it recognises that banks have smaller losses in lending to SMEs than in lending to big corporates. On the other hand this preferential treatment does not go far enough. In Europe a balancing factor of 0,7619 to determine the risk weight of exposure to SMEs up to a maximum of € 1.5 million (see Art 501 CRR) is adopted. We believe that the SME category within corporates exposures should receive a 75% RW. Moreover, we think that the combined effect of the: (i) 85% risk weight for unrated exposures to corporate SMEs and (ii) 0,2% hard binding quantitative granularity criterion provided for retail exposures might result in an unintended disadvantage especially for smaller banks. Therefore, in order to avoid these unintended consequences, we believe the application of 75% risk weight for unrated exposures to corporate SMEs should be laid down and/or softening the granularity criterion for retail exposures (see later para. 4 on retail exposures).

In our view it is important to acknowledge risk mitigating features such as expanding eligible covers (commodities and physical collateral). The SA is borrower specific and does not take into account the structure, collateral and other security types. However, collateral is a very important risk mitigating element in lending to corporates. This extremely narrow approach effectively penalises sound business models such as Commodity Finance (or Project Finance), which are all important for the real economy.

Finally, we believe that the impact of third-party guarantees should be more strongly emphasized in the prudential framework. Especially in the case of loan agreements for entrepreneurs, credit institutions regularly obtain third-party guarantees as an additional collateral. These guarantees significantly reduce the risk of a certain counterparty and should be taken into account when defining the risk weights. Thus, exposures which currently fall in the corporate exposure class should fall into the retail class if a third-party guarantee is assigned to a certain exposure.

Focus on introduction of due diligence

According to the second CP on SA a bank would determine the "base" risk of an exposure based on the external rating and perform due diligence to ensure that the rating appropriately reflects the credit risk.

Due diligence should never result in a lower risk weight. This approach would lead to disadvantages as follows:

- No reduction of reliance on external ratings as they form the base risk weight;
- No incentive for banks to evaluate a more comprehensive due diligence;
- Disproportionate burden (especially for smaller institutions).

The Proposal does not provide any information regarding the extent of the proposed due diligence. Depending on the required extent the implementation of, the administration of and compliance with a due diligence process could lead to high costs and therefore especially for smaller institutions to a disproportionate burden. Therefore we believe that any due diligence process should not be compulsory but rather optional.

Additionally, solicited external ratings are usually based on a comprehensive review of the company which can take up to many weeks or even months. We do not believe that any proportionate due diligence by a credit institution could reach the granularity of information which is been gained by a ECAI through a rating process.

Finally, the reliance on external ratings cannot be reduced if any foreseen due diligence process could only result in higher risk weights. The achievement of the Committee's aim is only possible if an optional due diligence process could also lead to a lower risk weight. In this event on the one hand the significance of external ratings could be reduced as external ratings could only provide an indication instead of setting a floor for risk weights. On the other hand, the possibility of lower risk weights could also form an incentive for institutions to evaluate a more detailed due diligence process.

The achievement of the Committee's aim (reduction of reliance on external ratings) is only possible if an optional due diligence process could also result in a lower risk weight.

For the avoidance of any disproportionate burden – especially for smaller banks - due diligence analyses should be optional rather than compulsory.

5. ***Retail exposures***

For retail exposures lower risk weights are needed for the purpose of financing SMEs to avoid credit squeezes. The granularity criterion after which no aggregate exposure to any single counterparty shall exceed 0.2% of the overall regulatory retail portfolio in particular discriminates smaller banks. Although the Committee has introduced a deviation from the 0,2% if the national authority has determined another method to ensure satisfactory diversification. However we still see no need to boost the granularity criterion to an obligation. Therefore the granularity criterion shall further be only a simple recommendation of the Basel Committee. Furthermore the proposal keeps the current low value of individual exposures: the maximum aggregated exposure to one counterparty cannot exceed an absolute threshold of € 1 million. We believe that this threshold should be raised to € 1,5 million (the level of € 1 million was determined before 2003) and adjusted to inflation on a regular basis.

Definition of SME

We appreciate that the new consultative document introduces a definition of SME (reported sales for consolidated group less than € 50 million). However, as recalled above, we believe that exposures to SMEs where personal guarantees are given should qualify as part of the regulatory retail portfolio.

Granularity criterion

The BCBS rightly considers the diversification criterion to be one of the primary justifications for the current preferential treatment. However, adopting a 'one-size-fits-all' approach in this area, and setting a very low threshold, is likely to result in unintended negative consequences. Indeed, for institutions with small portfolios the proposed thresholds can be reached very easily. Therefore, small business-retail customers of smaller banks would be strongly discriminated and competition within the banking sector is likely to be distorted via the prudential regulation. This can entail significant drawbacks; in particular the specific business model of local banks (informally-intensive and traditional lending activity, i.e. so called relationship lending) might be negatively affected by the prudential regulation, mainly for two reasons:

- The 'too-small-to-survive/succeed problem' would be exacerbated due to regulatory-induced incentives to grow in size (while in some cases merger operations are the principal way to increase efficiency and strengthen the resilience of very small banks this principle cannot hold true for every case);
- 'Multiple banking relationships' can be one of the banks' reactions. As a result the commitment of the bank towards the SMEs-borrower would be weakened and in turn the pursuing of the typical benefits of the relationship lending would be jeopardized. Therefore, 'multiple banking relationships' might result in a degeneration of the basic management criteria of diversification.

Offering national discretion as 'emergency exit' (section 1.4 footnote 10) contradicts one mentioned main objective of SA review to reduce national discretions. It is imperative for the growth of regional economies to maintain the availability of credit to retail individuals by smaller credit institutions. In some cases, the market area of credit institutions is even restricted to a very limited number of municipalities. The proposed 0.2% of granularity criteria would impose harsh constraints on credit availability, and raise pressure on supervisors and policy makers to ensure that local economy is unharmed by imposing relatively too strict thresholds. We still see no need to boost the granularity criterion to an obligation. Therefore the granularity criterion shall further be only a simple recommendation of the Committee. Additionally or alternatively, in light the of the above considerations, a proportional approach could be envisaged for credit institutions with a retail portfolio (without taking account of granularity criterion) below a certain threshold (e.g. €500 million (0.2%=1/500)) to be subject only to the loan size criterion removing 0.2% granularity criteria.

We agree with the indication of footnote 40 that no circular calculation has to be made and that granularity criterion is to be verified only once.

Loan size criterion

As for the threshold value of individual exposures, we believe that it should be raised to €1,5 million (this level was determined at least 12 years ago) and adjusted to inflation on a regular basis.

The risk weight for retail exposures might even be not sufficiently risk sensitive and excessively punitive for good quality portfolios. Therefore, even increased granularity (with a cap at 75%) of the risk weights could be envisaged in order to more accurately reflect the borrower's credit quality. In this respect, we propose to take into account additional drivers in order to enhance the risk sensitivity and to align with the treatment under the IRB approach. For instance:

- variables directly linked to the behaviour of a particular product/customer.
- variables associated with the length of the relationship with the customer.
- the maturity of the exposure. Both intuition and empirical evidence indicate that long-term credits are riskier than short-term credits.

Moreover, we also believe that the framework should recognise the risk mitigating arrangements included in certain retail transactions, such as loans collateralised by durable goods (e.g. reservation of title in financing vehicles). Indeed, we consider that the second hand auto market is very liquid and countercyclical. The guarantee can be converted into cash in a short time frame and the sale of second hand autos has increased during the crisis.

About this aspect, we propose a specific supervisory treatment for Salary Secured Loans and Pension Secured Loans (SSLPSL) and retail leasing exposures.

In particular, SSLPSL represent a particular technical form of consumer credit which is supported by a series of guarantees that reduce the credit risk in comparison with other forms of retail loans. SSLPSL clearly have numerous characteristics that mitigate risk: accordingly, a favourable prudential treatment (risk weight lower than 75%) should be applied.

In Italy for instance, SSLPSL are ruled by the law and by secondary regulation. This kind of consumer credit is supported by a series of guarantees that reduce the credit risk in comparison with other forms of retail loans. Namely, these guarantees are:

- direct assignment of one-fifth of the pension or salary to cover payment of the loan instalments;
- mandatory insurance policies ("life cover" for loans involving the assignment of one-fifth of pension and "life and loss cover" for transactions involving the assignment of one-fifth of salary);
- transfer of the effects of the assignment of salary to the pension when the borrower retires;
- restrictions on availability of retirement bonus (so called Trattamento di Fine rapporto – TFR) and/or similar indemnities, with immediate recourse available to the creditor;
- restrictions on possible attachments and seizures of the salary/pension that guarantee the privileges of the lender in comparison with other creditors.

SSLPSL clearly have numerous characteristics that mitigate risk: accordingly, favourable prudential treatment should be applied with respect to alternative forms of consumer credit. The evidence of a low level of credit risk is supported by the outcome of a sample survey carried out by the Italian Banking Association (ABI) that, with reference to pensioners and public employees, showed that:

- the probability of default (PD) within 12 months is 3.0%;
- there is 32.6% return to performing status within one year;
- the effective loss rate (weighted-average LGD rate) is 5.8%;
- the expected loss (EL) is 0.16%.

Accordingly, the theoretical RW factor, calculated on the retail curve, is 8.4% (compared with the regulatory parameter using the current standard method of 75%). In view of this evidence, it is requested that SSLPSL be recognised as loans less riskier than the retail portfolio loans and deserve a RW really lower than the current RW for retail portfolio (75%).

6. ***Credit conversion factors (CCFs)***

The consultative document proposes to significantly increase the capitalization of certain OBS commitments, which will have an adverse impact on lending activities for banks globally. Indeed, the second consultative document proposes to apply higher credit conversion factors (CCF) for unconditionally cancellable commitments (UCC) than envisioned in the 2014 proposal by the Committee. In particular, the contemplated removal of the 0% CCF is unduly punitive, and does not give an adequate view of underlying risks – especially on unconditionally cancellable commitments. We also believe the proposed CCF of 50-75% for UCC other than retail is overly conservative as it does not reflect actual usage ratios of such credit lines. It is also worth noticing that the combined effect of the:

- 50-75% CCF for non-retail commitments that are unconditionally cancellable at any time by bank without prior notice; and
- 0,2% hard binding quantitative granularity criterion provided for retail exposures;

might result in an undue disadvantage especially for smaller institutions.

Furthermore, the application of a CCF different than 0% for 'Unconditionally Cancellable Commitments' (UCC) raises many questions since the concept of commitment that can be cancellable at any time without conditions is somehow contradictory: if a bank can cancel the so-called commitment, then it is not a commitment, *stricto sensu*. The concept of UCC had been introduced by the Committee in 1988 with a 0% CCF. As far as the level of 0% CCF was in place, the definition of UCC was of no importance. Now that the Committee has proposed to apply a CCF different from 0%, it should be clarified what is a commitment and what is not a commitment for banks' practices.

Moreover, in order to enhance risk sensitivity and strengthen the link between the standardised approach and the internal ratings-based approach, we propose including the credit/revolving utilisation ratio as well as the commitment's maturity and product as additional drivers to determine the CCFs of commitments not unconditionally cancellable:

- Commitment's maturity is an important driver that is already captured in the current standardised approach and in the IRB approach. We suggest applying different CCF depending on the commitment's maturity and the product, in order to ensure a risk sensitive approach.
- Credit/ revolving utilisation ratio, which represents the credit balances relative to the credit limits on the revolving facility, should be calculated not only at aggregate level but also individual level, as long as the card/facility is still open.

Differences in application of the CCF in different jurisdiction should be taken into account. Incorrect and too high CCFs would unnecessarily increase market volatility and could lead to shorter credit lines (less undrawn commitments) with a negative impact on the real economy.

We note the Committee's proposals in this regard are meant to reflect the results of empirical evidence, including the 2014 QIS, which is stated to have shown consistency in these proposals with the CCFs applied under the IRB approach. We respectfully submit that by applying certain new variables in future analysis in this area may better reflect how CCFs are generally applied to OBS items. This could include a rigorous definition of UCC and a calibration against realized CCFs rather than IRB estimates, which may be subject to different modelling or supervisory practices or may not homogenous in terms of national accounting or business practices.

7. <u>Exposures to securities firm and other financial institutions</u>

The definition for securities firm and other financial institutions would leave a number of institutions out of the scope of this category of exposures (which will be treated as exposures to banks), thus including them among the corporates. In particular, it is not clear if financial institutions which are subject to the main but not all the prudential standards and a level of supervision equivalent to those applied to banks fall within this category. For instance, in Europe this could be the case of the investment firms which are subject to risk-based regulatory capital and other prudential requirements but not to liquidity requirements. The exclusion of the investment firms would clearly contradict an accurate risk representation and an increased risk sensitivity. We also suggest specific risk weights should be introduced for other regulated financial entities, like insurance companies. They would otherwise have to be treated as "corporates", while the suggested risk drivers for corporates, including their calibration seem to be inappropriate for such entities and, in general, the regulated ones.

8. ***Credit risk mitigation (CRM) techniques***

The collaterals in auto-loans and high quality consumer credit has a value and could be computed for CRM purposes.
Finally, the new standardised approach for measuring counterparty credit risk exposures includes the collateral posted in the EAD formula. Thus, these guarantees, cash or securities, are not subject to credit risk charge. Even the formula for calculating the EAD for SFT with GMRA (see par. 164) recognizes the side in both directions, received and paid. For these reasons we suggest the phrase "as will the posting of securities in connection with derivatives exposures or with any other borrowing transaction" be deleted in paragraph 129 of Annex 1.