

European Association of Guarantee Institutions – AECM

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**AECM's comments on the
Basel Committee on Banking Supervision's
Second consultative document
"Revisions to the Standardised Approach for credit risk"**

Brussels, 11 March 2016

A/Introductory remarks

AECM's 42 members, who are mutual / private sector guarantee schemes, public institutions or mixed, all have in common the mission of providing guarantees for entrepreneurs, small and medium-sized enterprises (SMEs) and freelance professions who have an economically sound project but do not dispose of sufficient bankable collateral. The guarantee provided by AECM's members constitutes a full-value collateral and for a significant amount of AECM's members it reduces the capital adequacy requirements in favour of credit institutions.

AECM represents the political interests of its member organizations both towards the European Institutions, such as the European Commission, the European Parliament and Council, as well as towards other, multilateral bodies, among which the European Investment Bank (EIB), the European Investment Fund (EIF), the Bank for International Settlement (BIS), the OECD, the World Bank, etc. It deals primarily with issues related to prudential supervision, to state aid regulation relevant for guarantee schemes within the internal market and to European support programs.

The development and maintenance of SMEs is paramount for AECM and its members. The activities of the guarantee institutions have to be sustainable and quite some members are obliged by national law to observe CRR legislation.

B/As to the consultation

This consultation document pursues the objective of formulating the standardised approach for credit risk in a more risk-sensitive way while at the same time keeping ease of application at the forefront of the review. The basic objective is, furthermore, not to increase capital requirements for credit institutions.

AECM supports such objectives, yet as to the concrete wording of the draft, we perceive a substantial tightening of existing requirements, which would have far-reaching consequences for the financing of the SME sector. We would like to stress that the current standardised approach for credit risk has proved a success in terms of content and that a complete overhaul, even in light of the financial and economic crisis, is not justifiable for smaller institutions.

1. Counterparty risks for banks

According to the proposals in the second draft, the use of external ratings for the calculation of risk weights under the standardised approach shall still be limited in that the credit ratings used shall be checked for plausibility through a due diligence process. The precise content requirements for this due diligence, however, are not described in sufficient detail. Both, the extension in the form of an annual review of the risk profile and the characteristics of each counterparty, have to be seen critically. Generally, the risk of debt is reflected according to the rating of a recognised rating agency. The rating agencies have extensive information on the financial position of the financial institution in question and assess this continuously based on a forward-looking method. We doubt that the aspects envisaged as part of the consultation document represent a significant qualitative added value compared to the previous practice. We would also like to emphasise that this process represents, especially for small credit institutions, a considerable additional burden that is disproportionate to the value to be drawn from this.

In the future, state guarantees to banks shall no longer be considered in the use of credit ratings which we regard as inappropriate given that the revision of counterparty risks for states is to be dealt with in the context of a later review.

Against this background, we consider it appropriate to maintain the concept of external ratings in the standardised approach for credit risk.

The second draft provides for a complete departure from the use of the country of domicile method. The draft stipulates that banks without ratings shall be divided into three classes, in which compliance with the respective regulatory minimum requirements shall be considered.

Having in mind that the use of the country of domicile method has proved itself over many years we do not support this approach. We prefer the approach that, if no external rating is available, the risk weight for counterparty risks for banks should continue to be determined in accordance with the country of domicile method. According to this method, the risk weight for counterparty risks is derived from the credit rating of the country in which the respective institution has its registered office. The country of domicile hereby reflects the regulatory framework conditions in the respective country and allows conclusions to be drawn about the robust and resilient supervisory regime in the relevant country of domicile.

Maintaining the country of domicile method is particularly valid given the fact that the counterparty's risks of states are not supposed to be under review with the draft submitted by the Basel Committee.

Furthermore, we view the general tightening to be questionable and not practical. These adjustments do not take into account the development of the banking industry in the context of the modernisation measures of Basel III. The new regulatory developments have been reflected in the stability of the institutions. There does not seem to be any justification to increase risk weights generally at this stage.

2. Counterparty risks for businesses

According to the present consultation document, the plan in respect of counterparty risks for the corporate exposure class shall be, similarly to the procedure for counterparty risks for banks, to restrict the use of external ratings of the borrowing business concerned to the extent that any possible rating existing shall be checked by means of a due diligence assessment.

The risk profile and characteristics of the counterparty shall be investigated at least annually. Particularly for small credit institutions, the data acquisition – which could essentially prove to be very difficult in some cases – represents an extreme amount of effort. Unrated exposures of the corporate exposure class shall continue to receive a risk weight of 100%.

a. Especially no less favourable treatment of SMEs

It follows from the consultation document that SMEs shall be treated less favourably compared to large companies what we regard very critically. Generally speaking, the SME sector plays an important role in the EU economy. SMEs are financed in particular by loans, because the offer of financing options for this group of companies is rather limited compared to the many funding opportunities available to large companies. The financing costs for SMEs would be increased by the measures proposed in the present consultation document. This is the reason why we see the risk that access to funding will become even more difficult for SMEs if the provisions foreseen in the draft document will be implemented and applied in the foreseen way.

b. Counterparty risks for retail

Regarding the counterparty risks of the retail exposure class, AECM would like to stress that the standardised approach for credit risk has proved to be successful and accordingly, we do not see any actual need for adjustment. The retail sector shall in future be divided into "regulatory retail" and "other retail" exposures.

To be assigned to "regulatory retail" the following criteria must be met:

- Borrower must be an individual person or SME
- Exposure must come from the product types: revolving credit, credit line, private credit and leasing as well as line of credit and commitment for micro-enterprises
- Total amount owed by a debtor must not exceed the amount of 1 million EUR
- The aggregated loans of a debtor may not exceed 0.2% of the "regulatory retail" portfolio

We would like to emphasize that it is imperative that the objective applicability refers to those SMEs which are at the lower end of this category of these enterprises, whereby the definition of SMEs corresponds to the definition of the IRB approach.

Similarly, the consultation paper outlines that the granularity criterion of 0.2% of the retail portfolio, to which a benchmark has hitherto been attached, shall now have mandatory application. This proposed change seems problematic to us, as this would mean that loan amounts would decrease. Particularly for small banks with a local customer base, this would create a considerable financial obstacle.

It is absolutely imperative that counterparty risks of businesses can be allocated to the "regulatory retail" counterparty risk area up to an exposure level of 1 million EUR.

Especially in the field of retail business we consider simple methods of low complexity for risk assessments to be crucially important. It is in this area in particular that the cost of borrowing and the expenses associated with investigations must be kept within limits so as to be able to represent proper financing for SMEs.

3. Off-balance sheet exposures

Among the further weaknesses identified by the Committee in relation to the standardised approach for credit risk is the calibration of credit conversion factors. The assessment of off-balance sheet items within the context of credit conversion factors is also to be tightened up according to the second draft, if the comments from the first consultation have been taken into consideration positively. Agreements that are unconditionally cancellable and due at any time shall be assessed with a risk weighting of 10-20%. All other agreements are assigned a risk weight of 50-75%. In the previous standardised approach for credit risk, the assessment depended on the term and ranged from between 20% to 50%. This consultation paper proposes a tightening here. We do not consider this significant tightening to be appropriate. Such an approach would result in a substantial increase in financing costs for SMEs. The possibilities of capital relief for banks through the acceptance of agreements in the area of off-balance sheet positions would thereby be significantly restricted. We do not consider this change in approach to be apt.

4. Credit risk mitigation techniques

In future, recognized provision of guarantees shall be significantly restricted in the context of credit risk mitigation techniques in such a way that protection sellers will only be recognised if they have been assigned a better risk weight than the institution buying the protection. We advocate keeping the existing arrangements as they are, as these can be applied in a practice-oriented manner. Detailed requirements for hedging instruments are already provided. Any further tightening, particularly of recognised guarantors, would not be appropriate.

5. Disclosure

The changes suggested in the credit risk standardised approach are expected to bring with them extensive changes in the area of disclosure. This applies for example for the exposure classes and also for the information that will be required for the due diligence measures to supplement the ratings. AECM would like to request that these extensive changes are taken adequately into account.

6. Implementation period

The period of implementation for the proposed changes in this consultation document remains questionable. We would like to draw particular attention to the specifics of small credit institutions who given their reduced resources require a significantly longer preliminary phase than is the case for large credit institutions.

Moreover, the technical preconditions associated with the requirements shall need a corresponding implementation period, which shall require a longer-term preparation. For an implementation of the requirements, the entire framework data must be clearly established. We cordially ask to take these reflections into your kind consideration regarding the further development of the standardised approach for credit risk.

7. Scope of application

The regulations of the Basel Committee have a direct effect on internationally active banks. Their application with respect to small credit institutions with a main focus of activity at national level remains open. In principle, the consultation paper provides for a possible extension of said regulations, meaning that an extended ripple effect on European regulations appears likely. Here, however, a clarification is necessary as to the extent to which Member States may extend and/or be allowed to adjust in certain areas the proposed regulations for non-internationally active businesses.

8. Grandfather policy

Finally, the consultation document contains no statement regarding the procedure for the assessment of positions that have been transferred prior to the suggested amendment by the consultation document. Here a grandfathering clause is essential. This point is directly related to the implementation deadlines. We assume that both the implementation deadlines and the grandfathering shall be at least seven years for banks not directly within the scope of application.

We cordially ask you to take our reflections as explained in this position paper into your kind consideration when revising the standardised approach for credit risk.