

Basel Committee of Banking Supervision

Division Bank and Insurance
Austrian Federal Economic Chamber
Wiedner Hauptstraße 63 | P.O. Box 320
1045 Vienna
T +43 (0)5 90 900-ext | F +43 (0)5 90 900-272
E bsbv@wko.at
W <http://wko.at/bsbv>

Your reference, Your message of

Our reference, contact person
BSBV 189/Dr.Egger

Extension
3137

Date
26.2.2016

Revisions to the Standardised Approach for Credit Risk - Second Consultative Document

The Division Bank and Insurance of the Austrian Federal Economic Chamber, as representative of the entire Austrian banking industry, appreciates the possibility to comment on the second consultative document on revisions to the standardised approach and would like to submit the following position:

General comments

We believe the objectives of the revised proposals to balance simplicity and risk sensitivity, to promote comparability by reducing variability in risk-weighted assets across banks and jurisdictions, and to ensure that the standardised approach (SA) constitutes a suitable alternative and complement to the Internal Ratings-Based Approach (IRB) are better achieved by making available use of external ratings rather than relying solely on the originally envisioned “financial ratios” approach. The second consultative document improves the important balance between simplicity and granularity in this regard.

Taking into account the valuable and considered work of the Committee for the second consultative proposal, we believe that aspects of the consultation would, however, benefit from further review and consideration to ensure the mitigation of potential unintended consequences.

The Committee should take into consideration the objectives and aims of worldwide economic politics. Currently worldwide governments are trying to achieve full employment and adequate economic growth. It would not make sense to propose new risk weights for certain exposures disregarding the consequences on economic growth and the maintenance of jobs (especially with regard to equity holdings). Therefore an alignment of the second consultative document with the general objective of worldwide economic politics should be ensured by the Committee before the final standard is published.

It will also be vital for the Committee to examine the revisions to the standardised approach closely in the context of its interaction with any ultimate proposal for implementation of a

capital floor to the Internal Ratings Based Approach. The final impact of some proposals in the consultative document should on the one hand be considered for its effect on a bank that solely uses the standardised approach for the determination of its credit risk capital requirements, and for which simplicity may be an important element, and on the other hand on a bank that may face capital requirements from the SA as a floor to its IRB-based RWA, where risk sensitivity will be more important.

Where IRB is applied we also find it particularly difficult to comment fully on the proposed approach (and especially on the RW levels) without any precise view of the future relationship between the RWA under SA and IRB. The nature of our comments may evolve following any future release regarding the level and structure of a floor and as such we encourage further consultation with the industry on the SA framework in concert with any future decision on the calibration of a capital floor for the IRB approach. In the absence of precision on the expected granularity of a possible floor, the risk sensitivity of the RW under SA should be a major objective of the reform, which does not seem to be the case in the current consultative proposal.

Additionally, where the Committee is working to reduce a mechanistic reliance on ratings, careful consideration should be given on whether to further enhance disclosure requirements. We would like to emphasize that there is a difference between the methods used for credit assessments in approval processes and calculation of capital requirements. It is not the case that banks rely on external ratings for credit assessments in the same way as they use them for capital calculations. The BCBS principles for the management of credit risk (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.

The Committee should also carefully evaluate the proposals in areas where they will 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 have increased substantially relative to the current SA and IRB. As 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), capital requirements will increase under the current proposals in a way that could detrimentally impact a bank's ability to lend under certain products.

Furthermore, an in-depth analysis should be undertaken not only to gauge the impact but also to assess the appropriateness of the revised proposals. In this regard, the industry supports the upcoming Basel monitoring exercise that will include a QIS on the credit risk SA.

The new proposal would increase the RWA by approximately 10 to 20 %. This significant increase would be caused mainly by the add-on for currency mismatch, higher CCFs and higher riskweights for real-estate lending. We believe that such an increase should be mitigated in order to avoid negative consequences for businesses and individuals.

Finally, 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 in the implementation timeline the processes that each jurisdiction has to go through to transpose international standards to local rules.

Main priorities

- **Existing equity exposures or well-diversified portfolios of equity investments should receive the same risk weight as under the current regime (100 %).**
- **The final calibration of the new rules should ensure that on average no increase of capital requirements is caused.**
- **For retail exposures the granularity criterion of 0,2 % shall further be only a simple recommendation.**
- **The calculation of the LTV-ratio should be reconsidered. Risk mitigants and provisions should be included in the calculation.**

Concerns regarding the due diligence process

Although we welcome the Committee’s view to maintain the current approach of the usage of external ratings we have some serious doubts regarding the introduction of any due diligence process. This additional requirement contests the value of an external rating and raises the question why a document for the standardized approach provides a case-by-case due diligence test. One of the main assets of the standardized approach is that credit institutions do not have to execute an in depth analysis of every single counterparty but may rely on external ratings. It is against the spirit of the standardized approach to assess the financial performance of each counterparty by a due diligence test.

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 an ECAI through a rating process.

An internal due diligence process means effectively that institutions have to do an internal rating based approach. Such a regulation does not fulfill the fundamental principles of a standardised approach. As a consequence of the proposed internal assessment, different institutions will get different risk weights for the same exposure.

The proposal does not provide information regarding the extent of the proposed due diligence. Depending on the required extent the implementation, the administration and compliance with a due diligence process could lead to high costs and therefore especially for smaller institutions to a disproportionate burden.

The proposal does not provide any details regarding the extent of the due diligence process. Therefore institutions have to deal with legal uncertainty, i.e. how such a due diligence process should be implemented or which parameters have to be used.

We understand the proposal with regard to the due diligence in a way that banks should be able to have in place effective processes which ensure that appropriate risk weights are assigned to the overall portfolios rather than to each counterparty. We think that the Committee wants credit institutions to review the provided risk weights by their own experience of default in the past with certain portfolios. If the experience of the credit institution with overall portfolios fits with the risk weights foreseen in the Basel standard these risk weights shall apply. However the Committee would have to clarify and emphasize this understanding in the text as the consultative document could also be understood in a way that every exposure has to be contested by a due diligence process (see especially Annex point 14 the wording “...as appropriate for each counterparty.”).

If the committee implements the due diligence process despite the raised concerns, it is absolutely important that institutions are allowed to use their current internal assessments of pillar 2 for this purpose. This is the best practicable and reasonable approach for such a due diligence process because the assessment of pillar 2 is approved and regularly monitored by national supervisors. Otherwise, institutions have to develop a second internal assessment process which is economically and operationally inefficient and unreasonably burdensome. Furthermore, institutions will receive and have to explain different results from their two differing assessments.

The proposal should explicitly mention that the internal assessment of pillar 2 has to be used for the due diligence 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.

Bank exposures - External Credit Risk Assessment Approach (ECRA)

We acknowledge the recognition of the limitations of the two risk driver approach originally envisioned by the Committee has led to a number of positive changes in the scope of the proposals outlined, including the reintroduction of the use of external credit ratings. Though we understand the Committee’s objective to avoid the mechanistic reliance on ratings, we believe there are several outstanding issues to be addressed relative to the methodology of due diligence proposed by the BCBS in the current consultation.

Additionally, we strongly disagree with the fact that RW derived from the internal due diligence should only be higher than RWs derived from external ratings. We believe this will harm the value of the internal due diligence process and the added value of internal credit analysis. Due diligence should be able to result in the application of better RW levels where the results are appropriate to do so.

The Committee’s belief that banks’ external ratings as used for regulatory capital purposes should exclude government support 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 in some cases have

already removed 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.

Furthermore the rules require 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 footnote 35 making clear, 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.

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. 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 standardized approach. The comparability of capital requirements is most suitable with the current standardized approach.

Bank exposures - Standardised Credit Risk Assessment Approach (SCRA)

The proposal of a bucket approach for unrated exposure is a reasonable and practical solution as long as all the required data can be provided by a central provider. If such a centralised database cannot be provided, the approach should be revised. In this case the current approach based on the country ratings is preferred. Data collection carried out by each institution itself is economically inefficient. Especially for smaller banks it is a significant burden to monitor all national standards of the home countries of the banks in their portfolio. Maybe, the committee should think to develop such a database on its own with the advantage to get data on a regular basis for own purpose or to force national supervisors to provide the required data in a standardised database. At least, all the parameters required to decide the right grade has to be reported publically in a suitable way. If it is not possible to provide all necessary data in an adequate way, this regulation will discriminate institutions without a rating. For these institutions the access to interbank loans will be more difficult, because some institutions will either charge higher margins or stop to make business with unrated

institutions to prevent themselves from the administrative costs that come along with the bucket approach.

The Committee notes that 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) 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.

We think that the criteria and triggers applied under SCRA for Grades A to C are imprecise, not necessarily aligned to banks business models (in particular, the criteria for repayments of principal and interest would appear more applicable to corporate debtors) and it will likely be very 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 burdensome for countries like Austria with large populations of unrated savings and cooperative banks. Under Basel II, these countries generally chose the option to base the risk weight on the risk weight of the sovereign. In the EU, unrated banks still receive a risk weight which is based on the risk of the sovereign rather than requiring a more elaborate assessment. This appears to be a more appropriate solution for a standardised approach which should be simple to use.

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. 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 we share 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 same exposures subject to convertibility and transfer risks and guaranteed by a Multilateral Development Bank (MDB). In the same vein, we also believe that 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.

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 to a positive increase in market liquidity in interbank markets.

The reduction of the risk weights for short-term claims is reasonable. But the definition of short-term claims should be based on “residual maturity” instead of “original maturity”. It is not comprehensible that a one year investment with a residual maturity of one month should receive a different risk weight than a new one month investment at the same institution. Obviously, both investments bear the same risk.

Exposures to Securities Firms and Other Financial Institutions

Under Paragraph 30 of the consultation document on exposures to securities firms and other financial institutions, the Committee refers to the “risk drivers used to ascertain the applicable risk weights (or the information to calculate them)”. We note this reference relates to the 2014 consultation prior to the removal of risk drivers from the perspective of the application of the SA and we respectfully request clarification as to treatment of these exposures under the current approach.

We think it should be clearly stated how the decision on whether the criteria to treat the exposures to securities firms and other financial institutions as exposures to banks is to be fulfilled and how this is/can be made available to the industry (“...provided that these firms are subject to prudential standards and a level of supervision equivalent to those applied to banks (including capital and liquidity requirements...)”). We are wondering whether this will be subject to a national discretion (i.e. a published list by the local supervisors), a case-by-case decision by regulators or a discretion for the institution itself?

Corporate Exposures

Again, we are grateful the Committee decided through the prior consultation that a bank should determine the “base” risk weight of the rated corporate exposure according to a look-up table based on external ratings and that the proposed “risk drivers” of the 2014 consultation were inappropriate to this category of exposure.

However, many of our concerns outlined for due diligence requirements applied to bank exposures also apply to corporate exposures.

In addition to the need for further discussion on due diligence standards, the risk weighting of certain corporate exposures should be revisited. In particular, we believe consideration should be given to the RW of a BBB corporate exposure. The RW of BBB (i.e. investment grade) corporate exposure is proposed as 100%, the same as BB (i.e. non-investment grade). We believe BBB has better credit quality than BB, so for a more risk sensitive framework, RW for BBB corporate exposure should be revised lower (e.g. to 50%).

According to paragraph 36 of the consultation, banks may apply a 75% risk weight to “investment grade” corporates in jurisdictions that do not allow the use of external ratings for regulatory purposes. We suggest extending this possibility to unrated exposures to corporates in jurisdictions that apply external ratings, as it was done with corporate SMEs. The proposed treatment would be aligned with the hierarchy for unrated banks using ECRA approach that can classify them in grades A, B or C.

For SME exposures, we strongly agree with the application of a reduced risk weight, however, we believe given the nature of SME lending and also in the light of the EU Capital Market

Union's aim to reduce barriers for SME financing, the risk weighting should be applied lower than the proposed 85%, e.g. 75%.

Furthermore we think that third-party guarantees should be stronger emphasized in the prudential framework. Especially in cases of loan agreements for entrepreneurs credit institutions regularly obtain third-party guarantees as an additional collateral. These guarantees reduce the risk of a certain counterparty significantly and should be taken into consideration when defining the risk weights. Therefore credits which would fall currently in the corporate exposure class should fall into the retail class if a third-party guarantee is assigned to a certain exposure.

Lastly, the 'investment grade' criterion under paragraph 173 requires corporate entities to have securities outstanding on a recognized securities exchange. We question if this criterion is relevant for determining the creditworthiness of corporates. Further, the share of corporates having securities outstanding on a recognized securities exchange differs significantly between jurisdictions. To mitigate this issue, the Committee should consider allowing national regulators to define additional criteria that fit better to the local environment.

Specialized Lending to Corporates

We have additional concerns regarding the treatment of specialized lending to corporates. Though we are grateful that the Committee recognized certain limitations in the original proposal in this area, outstanding issues remain where external ratings are either not available or not allowed to be applied in this area and flat risk weights are applied to object and commodity finance exposures and for project finance exposures. The Committee argued in the 2014 consultative document that these exposures generally exhibit higher risks and losses than other types of corporate lending. However, based on recent data analysis; the risk profile proposed by the Committee is, in our view, not justified.

With regard to project finance exposures we would ask the Committee to take into consideration the empirical evidence provided by a study of project finance default and recovery rates conducted by Moody's Investors Service¹. The study is based on a comprehensive data set of 5,308 projects over the time period from 1983 to 2013 and presents several relevant findings regarding the comparative risk profile of project finance loans.

The study finds that recovery rates of project finance loans averaged 80.3% with the most likely ultimate recovery rate being 100%. This compares with a volume-weighted average recovery rate of secured corporate bank loans of 60.2% over the period from 1982 to 2013. Consequently for rated exposures, instead of applying equal risk weights for corporate and project finance exposures within the same rating category the project finance risk weight should be lower than the corresponding corporate risk weight.

The results of the study imply that the proposed risk weight of 150% for unrated project finance exposures during the pre-operating phase does not reflect empirical evidence. The marginal annual default rates of project finance loans during a project's initial three years (i.e. the pre-operating phase) are found to be consistent with a BB credit quality. Thereafter

¹ The study is available at <https://www.moodys.com/Pages/PFSplashPage.aspx>.

the marginal annual default rates fall significantly and trend towards default rates observed in the single-A category. Accordingly it would seem appropriate to apply the risk weights of rated projects in those categories to unrated projects in the pre-operating respectively the operating phase.

In addition we would like to draw the Committee's attention to the class of infrastructure projects within the general project finance category. The Moody's study shows that default rates of infrastructure projects are significantly below the average default rate of general project finance loans. This indicates that the specific risk characteristics of this project category could warrant the assignment of separate lower risk weights. It should be noted that a similar approach is currently pursued in the insurance industry, where EIOPA (European Insurance and Occupational Pensions Authority) and the European Commission are proposing to reduce capital requirements specifically for infrastructure projects.

Finally, it should be noted that the risk weights proposed for project finance exposures also run counter to the European initiatives to promote investment in infrastructure (EFSI / Investment Plan for Europe). In particular the proposal could be expected to impede the implementation of small and medium projects where obtaining a rating would incur costs that are high relative to the overall project size.

Subordinated Debt, Equity and Other Capital Instruments

The Committee believes 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, compared with a currently appropriate risk weight of 100% for corporate exposures and subordinated debt. For subordinated debt and capital instruments other than equities below the threshold deductions the Committee proposes a 150% risk weight.

We see a massive conflict of interests between the objectives of politics and the proposals by the Committee.

While politics currently are taking enormous efforts to realize an adequate economic growth and to make new incentives to invest in the economy, the Committee is proposing higher risk weights for these investments. Under these new proposals enterprises would still hardly get own fund financing by banks and existing holdings would definitely be sold by banks. Especially in Europe banks hold significant holdings of enterprises of high interest for the overall economy.

The proposed risk-weights would have a massive impact on the regulatory capital requirements for existing investments. The holding of participations would dramatically increase in price for banks, respectively could no longer be affordable. If the risk weight of 250% would have been known or if banks, who apply the standardised approach would have reckoned that the capital requirement for investments (in equity) will be raised by 250 %, many investments would not have been made. With this planned enormous increase in costs it is intended to force back banks as equity investors, for example for industrial companies, but this will have inestimable consequences on the growth and location of these companies.

The increase of these risk weights will definitely 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 and the regulatory aim of increasing

bank's capital. Strategically important and economically healthy investments in domestic enterprises would be reserves which would mean a serious damage for the local economic competitiveness. Many headquarters and jobs would be threatened due to disinvestment flows. In general this could harm economic growth.

The Committee does not explain for what reasons the risk weights for these exposures shall be increased. In the document it is only indicated that the standardized approach shall be converged to the IRB approach. However these approaches have completely different objectives therefore reasoning for such a change in the prudential framework should be provided at least. We have the impression that this issue is in certain areas of the world of highest importance whereas other parts of the world would not have similar challenges. Europe is an area where the standardized approach is used by credit institutions to a high degree. Therefore also a lot of credit institutions in Europe would be penalised if these new risk weights were to be realized. 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 steep increase of risk weights for participations this disadvantage for mainly smaller and medium sized banks would further be increased.

Furthermore in times of low interest rates investments in enterprises may provide an additional source of revenues beside the traditional bank business. Moreover the supervisors demand from credit institutions to find new sources of revenues to have a sustainable business model (see the Supervisory Review and Evaluation Process in Europe). Equity holdings and other capital instruments are a source of these additional revenues and should therefore be rather promoted than penalised.

Furthermore especially the banking industry is the world's most regulated and supervised economic sector. Therefore it seems to be quite contradictory to increase the risk weights for investments in other banks. In addition stock companies 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. Therefore also the increase of risk weights for these exposures does not seem to be adequate.

However, also for other legal forms of enterprises increasing risk weights are not justified at all as the equity portfolio of a bank is in any case examined by auditors and supervisors. Against the background of the current business environment investments in equity should be particularly supported (see also the Initiative of the European Commission for a Capital Markets Union). For this reasons the current applicable risk weights for equity exposures under the CRR are sufficient.

To mitigate the serious interventions for banks who apply the standardised approach it is essential that the risk weights for existing subordinated debt, equity and other capital instruments remain at their current level under the CRR. 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.

In this context it would be conceivable to restrict future acquisitions of equity holdings over a longer transition period. A possible alternative for the supervisory treatment of the prospective purchase of equity holdings could be to differentiate if the equity investment in

the company is predominately funded by existing financial resources of the bank or by borrowing additional funds by the institution. The second case would justify the application of higher risk weights for equity exposures as under the current CRR-regime.

Regulatory Retail Exposures and Other Retail Exposures

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. Additionally, we believe the Committee should clarify that when individuals interact with a bank through a trust / SPV structure, the exposures would not strictly be to individual persons and that in such instances, if all other retail criteria are met, it would be incorrect to treat such an exposure stemming from private banking / wealth management as a corporate exposure.

For retail exposures lower risk weights are needed for the purpose of financing SME 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. The inclusion of a granularity criterion (0,2 % of the total regulatory retail portfolio) for a retail portfolio category is not appropriate, because especially small institutions cannot fulfill this criterion. In order to exploit the favorable risk weight of 75% to the retail ceiling of EUR 1 million, a bank would need a retail portfolio of least EUR 500 million, which does not apply to many banks in Austria. For example a sector in Austria with around 500 banks has currently an overall total balance sheet per bank of about EUR 550 million. So the EUR 500 million of a retail portfolio would not be adequate for these small banks. At least an institution has to have also more than 500 different borrowers ($1/0,2\% = 500$) to fulfill this criterion theoretically. Furthermore, this rule causes a “cliff”-effect.

For small institutions where the relative risk weighted exposure of a single retail exposure compared to the total assets reaches a certain level, a higher risk weight could be appropriate. If the committee wants to introduce the granularity criterion anyway, we suggest that the basis should be the total assets or total risk weighted assets, but not the overall regulatory retail portfolio.

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.

The consultation paper reads: “Granularity criterion: no aggregate exposure to any single counterparty³⁹ can exceed 0.2%⁴⁰ of the overall regulatory retail portfolio“. On the contrary, however, footnote 39 reads that “to one counterparty” means one or several entities that may be considered as a single beneficiary (e.g. in the case of a small business that is affiliated to another small business, the limit would apply to the bank’s aggregated exposure on both businesses). We believe the final text should be clear on whether the criterion should apply to a single entity or to several entities. The current text is unclear and

can cause interpretation in the future. Moreover, in footnote 40 it reads that “to avoid circular calculations, the granularity criterion will be verified only once”. In our opinion, the moment of verification should be further specified.

Having said this, in general as already outlined we are against a strict granularity criterion, because it penalizes very heavily smaller banks.

Real Estate Exposure Class

In general:

Residential real estate exposures and commercial real estate exposures are currently assigned a risk weight of 35 respectively 50 % under the CRR. The consultation paper provides an increase up to 150 %. 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.

It is unclear how a bank should deal with seasoned loans. We expect it to be nearly impossible to use the correct value of the financed property at the moment of origination, if the loan runs for many years. Additionally it is often very difficult to say, when a loan was originated. Problems can be caused by extensions of loans, increases of credit lines, changes of currency and restructurings of any kind.

According to Art 124 (2) CRR supervisory authorities already have the legal 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 there is no need for a change of the current regime.

The finished property criterion in paragraph 50 could have a massive impact on the whole real estate financing. Beside other requirements it provides that real estate exposures may also be assigned reduced risk weights if the property is finished. When constructing new buildings it is standard that the property securing the exposure is not fully completed. It should be born in mind what such an additional requirement could mean for the whole construction industry (see also our comments under “operational requirements”).

As paragraph 50 also applies to commercial real estate 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).

The Committee could consider applying a risk weight of 100% to “land acquisition, development and construction” once the SPV demonstrates higher certainty on repayments e.g. when a substantial volume of the property is sold or rented under contracts whose unilateral termination is subject to a fine for the purchaser.

Lastly, there are some residual inconsistencies present in the current consultative proposal. First, the combination of footnote 48 and para 55 and 59 seem 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). Further clarification in the areas by the Committee would prove helpful.

LTV is currently not always available and therefore the inclusion of LTV would lead to an additional financial burden. Maintaining the LTV as the primary risk driver could have the unintended effect of encouraging lending to customers with worse financial standing. Further, the use of LTV would result in a decrease of lending and an impairment of the real economy. Additionally, there should be significant advantages regarding risk weights maintained as incentives for collaterals.

Categories

The definition of an Income Producing Real Estate (IPRE) should be clarified, especially what “materially dependent” means in this case. If, in the case of default, the lender has the possibility to receive cash flows from other assets or other sources of income of the borrower, the exposure should not be categorised in this class.

In the revised proposal the definition of ADC exposure is not clear, especially the difference between IPRE and ADC exposure has to be defined better. It is important that this category is defined clearly to be able to categorize an institution’s exposure correctly.

We ask for clarification of the definitions of the different categories.

Moreover, non-profit oriented residential construction companies should be excluded from this category and treated like non-IPRE, since their business model would be seriously impaired despite their low risk profile (for details see section “Non-profit oriented residential construction companies” at the end).

Buy to let - (“Vorsorgewohnungen”)

Another concern is about “buy to let”. 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) because the banks build 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 does not really depend on the rental income. Even if the repayment depends on the rental income, the extent to which the proposed RWs are higher is out of all proportion to any realistic difference in risk. Austrian banks’ actual loss experience is that “buy to let” is not, or only slightly, riskier than their main owner

occupied book. Certainly their evidence challenges for instance the $60\% < \text{LTV} < 80\%$ bucket where the “materially dependent” category has an RW of 90%, even higher than the RW of 75% for retail unsecured exposures, while for owner occupied real estate exposure a RW of 35% is assigned.

Calculation of the LTV-ratio

It is reasonable to differentiate exposure secured by residential real estate by the LTV-ratio. We think that LTV is an appropriate indicator to estimate the loss in the event of default. However we disagree with the proposed calculation of the LTV. It is incomprehensible that risk mitigants and provisions are not deductible from the numerator of the LTV-ratio. Also it is not understandable that undrawn loan commitments have to be included.

Risk mitigants like on balance sheet netting effectively reduce the risk of the netted part of the loan. For the remaining part of the loan still the whole value of the property is available as collateral. Therefore it is reasonable that the LTV ratio is calculated just with the remaining part of the loan. In case of a default, the netted part of the loan will not cause any loss for the institution. For the remaining part of the loan, the total gains from the property are available to cover the losses. Effectively, it is the same risk as a loan with the same volume as the remaining part of the netted loan.

A: loan volume 150.000, value of property 125.000, on balance sheet netting 50.000, (operational requirements met)

B: loan volume 100.000, value of property 125.000, (operational requirements met)

For both loans, the value of the property has to cover a loan amount of 100.000 because for loan A 50.000 are secured by a netting arrangement. The risk for both loans is obviously equal:

A: $150.000 - 50.000 = 100.000$

B: 100.000

As the risk of the loans is the same, both should receive the same risk weight:

LTV: $100.000/125.000 = 80\% \rightarrow$ risk weight 35% $\rightarrow$ RWA 35.000 ($35\% \times 100.000$ net exposure)

But in the current proposal the risk weights would be as following:

A: LTV: $150.000/125.000 = 120\% \rightarrow$ risk weight 75% RWA 75.000 ($75\% \times (150.000 - 50.000)$)

B: LTV: $100.000/125.000 = 80\% \rightarrow$ risk weight 35% RWA 35.000

Both loans bear the same risk but will receive a significantly different risk weight.

It is not comprehensible that the LTV ratio should be calculated on the whole loan amount without taking into account the secured part. The value of the property is completely available for the part of the loan after the netting.

Also provisions should be deductible. Provisions for loans cause a reduction of own funds, so a provision has the same effect as a deduction of own funds or a risk weight of 1250%. So this part of the loan is effectively covered by the reduction of own funds and in case of default would have no further effect on own funds.

Provisions do not reduce the risk of an exposure, but they reduce the loss in case of default effectively. It is similar to on-balance sheet netting that the total value of the property just has to cover the remaining amount of the loan without provisions. Consequently, the LTV ratio should not be calculated gross of any provisions as proposed in the revised paper.

We also cannot agree that undrawn loan commitments should be included in the LTV ratio for this exposure class. Undrawn loan commitments usually occur with loans that finance the

construction of a property. The loan is granted for the total amount of the property, but paid out during the construction phase in line with the construction progress. Therefore the loan is paid out in line with the generation of the value of the property. Consequentially, there are undrawn loan commitments especially in the first stages of the construction.

Under the current revised proposal, the LTV-ratio is calculated with the full loan amount including undrawn parts, but the value of the property is valued according to the phase of construction. So in the beginning the LTV ratio is extremely high because the value of the property is low and the loan amount is taken into account completely. During the construction, the value of the property increases and the LTV decreases. The LTV ratio will not reach the right level until the property is finished. Such an approach would be correct, if the loan is paid out completely at the beginning of the construction phase. But because it is paid out in line with the construction progress, it does not reflect the risk of this exposure. Therefore, undrawn loan commitments should not be included in the calculation of the LTV ratio.

The exclusion of risk mitigants and provisions and inclusion of undrawn loan commitments for calculating the LTV ratio would result in absolute incorrect risk weights for real estate exposures. It is absolutely contrary to the aim to increase the risk-sensitivity. We urgently ask the Committee to rethink the calculation of the LTV ratio.

For the denominator of the LTV ratio it is not comprehensible that the value of the property should be kept stable, unless the national supervisor demands an update. If a bank gets new data, it should be allowed to update the LTV input parameters. Especially for mortgage loan that typically have long maturities it is not understandable to keep a high risk factor when the value of the property increases sustainably.

Loan splitting

The second consultation paper proposes that always the whole loan 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" - according to footnote 44 - "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."

This proposal would clearly depart from "tranching", which is reasonably practised across the EU under CRR and its predecessors. For example 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 not secured part. The part fully secured by residential real estate receives (if the other conditions are fulfilled) a risk weight of 35 % and the not secured part receives a risk weight according to the counterparty (e.g. 75 % when falling in the retail exposure class).

The proposed departure of this method of loan tranching or splitting is hardly acceptable:

- It creates sharp discontinuities at the high LTV end (see tables 9 to 12).
- It produces perverse incentives: For example a borrower, who needs 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, may be 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) further increases this problem: It is a common and sound procedure of 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 common practise is wise and diligent as it can help to keep 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 in respect of securing future exposures. This cannot really be intended by supervisors.

- The proposed departure of loan tranching is also in contradiction with the principal laid down in Paragraph 104 of the second consultative document: “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 telos of this principal it must also be applied when a CRM technique (real estate collateral) leads to a qualification as a separate exposure class in the SA.

Operational requirements

The inclusion of operational requirements is comprehensible in general, whereas we strongly disagree on the rule that the collateral property has to be finished to get the preferential treatment because it is not necessary in this context.

It is usual to pay out loans before or during the construction of the property. As mentioned for the LTV-ratio, the value of the property increases with the construction progress. So in the beginning the value of the property is low and the LTV ratio will be automatically higher and the exposure will receive a higher risk weight. During the construction, the value of the property increases and the LTV ratio and risk weight decrease. So the changing value of the property regulates the LTV ratio and risk weight automatically and it is not necessary to wait until a property is finished to get a preferential treatment.

Furthermore we would like to ask the Committee why the requirement of a “one-to-four family residential housing unit” has found consideration in the consultative document. According to the Committee this requirement shall release from the finished property criterion. However we assume that real estate markets differ considerably in different parts of the world and it seems to be inadequate to define such a criterion for all real-estate financing in the world.

However if the Committee wants to maintain this criterion at least the proposed national discretion for one to four family residential housing units should be a general, fixed exemption across all jurisdictions.

Moreover, based on the current proposal loans secured by real estate are discriminated compared to retail loans. It would be better to wait with the entry of the lien until the property is finished and all operational requirements are met. Until then the risk weight of 75% for retail loans or 85% for SME may be applied which is better than the minimum risk weight of real estate exposure of 100%.

Risk weights

Real estate exposure that does not meet the operational criteria is risk weighted at 100% or 150% which is not justifiable compared to a retail loan with a risk weight of 75%. In the case that an institution grants a loan that fulfills all criteria of a retail loan except that it is secured by a real estate, but does not meet the necessary operational requirements, the institution would receive a lower risk weight if it does not enter the lien in the land register. So if such a loan is unsecured it would receive a better risk weight than if it is secured by a

real estate. This is absolutely not comprehensible. We suggest to decrease the risk weights in case that the operational requirements are not met to 75%.

Even if the retail criteria to get a 75% risk weight is not fulfilled, it may be better to not secure a loan. For example a loan to individuals or corporates that has to be classified as IPRE may receive a risk weight of 120% or 150% in this category, whereas if it is unsecured it may receive a risk weight of 100% (other retail or unrated corporate exposure).

The risk weights of secured loans should be in any case better than an unsecured loan. The risk weights of loans secured by real estate should be recalibrated considering this principle. The proposed still does not differentiate between jurisdictions. We suggest a lower standard calibration of the risk weights combined with the opportunity for national regulators to charge add-ons on the risk weights for their jurisdiction. The calculation of the add-ons should be based on the national default rates of mortgage loans.

Grandfathering for real estate exposures

Finally, we do not believe that it is sensible to apply the new risk weights retrospectively to existing mortgages. Given the fairly rapid turnover of mortgage books, it would be more sensible to apply the new risk weights only to new loans advanced after the date of finalisation of the Basel rules, and not to require reallocation of older loans. This would have the effect of a more gradual transition to the new risk weights, without affecting the end-point.

Taxonomy of Real Estate Exposures

The Committee proposes to categorize income-producing real estate exposures and land acquisition, development and construction exposures as real estate exposures. However, the consultative proposal does not suggest that the existing IRB approach groupings will align to the new SA approach and thus for reasons of comparability we would suggest the exposure classes are fully aligned. Additionally, we propose a more granular categorization of LTVs where applicable to include, for example, LTVs of below 40% regardless of cash flow dependencies.

Risk Weight Add-on for Exposures with Currency Mismatch

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 requirements previously outlined in the consultative proposal and so it will lead to double counting of such risk.

We also think implementing add-on for currency mismatches to retail and real estate exposures is undesirable because it would increase complexity to the framework while the benefit is unclear. The add-on would create variance in treatment compared to the IRB approach, where such add-on is not required.

Corporates normally have income and expenses in several currencies and apply differentiated currency policies. A loan or other bank exposure to such corporates cannot be attributed to

specific currency income nor to specific currency hedging transactions. Such corporates normally apply appropriate general currency risk mitigation techniques and therefore the currency risk is sufficiently covered and no add-on is necessary. It would be inappropriate for corporate exposures to demand directly corresponding currency income or currency hedging transactions. Therefore the currency mismatch add-on shall not be applied to corporate exposures. An extreme example would be e.g. Siemens issuing a CHF-Bond. It would be odd to have to prove that Siemens has CHF-income to avoid the 50% add-on.

Furthermore we do not deem it appropriate to apply the same add-on without differentiation among strong borrowers with low risk weight and weak ones with high risk weight. There is no data available which would justify the disadvantageous treatment of low risk weight exposure. To the contrary: Strong borrowers will be able much more 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. One method may be to apply a multiplication factor to the original risk weight instead of adding the same add-on figure to both weak and strong original risk weights.

In addition, there is a question of alignment between the treatment of currency mismatches in the CRM framework and in the general credit risk framework, particularly where it relates to real estate exposures. The add-on in risk weight for real estate exposures should be linked to the potential for a mismatch in value between the loan and the collateral securing it - i.e. the value of the property (this would take into account the LGD dimension which is done in the CRM framework for non-real estate collateral). Therefore, it is not obvious why the haircut for a currency mismatch in the CRM framework is 8% while the increase in risk weight 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 would be warranted to properly calibrate the risk weight add-on for currency mismatches.

For all these reasons the undifferentiated, general risk weight add-on for exposures with a currency mismatch should be deleted or made subject to the default risk of the borrower.

Off-Balance Sheet Exposures (OBS)

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.

Additionally, such evolutions on the CCF values are likely to have undesirable side-effects on the computation and level of the leverage ratio, whereas the LR was meant to be a backstop measure largely independent from the credit risk metrics.

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 be homogenous in terms of national accounting or business practices.

Defaulted Exposures

We agree that credit risk mitigation techniques should apply consistently to both defaulted and non-defaulted exposures and that the definition of defaulted exposures should be aligned between A-IRB and the SA.

However, we believe that the proposal to apply a 150% risk weight for defaulted exposures net of specific provisions seems to be overestimated and pro-cyclical. As the Committee is aware, IFRS 9 is underway for finalization. In that sense, provisions will likely cover the expected losses for defaults in the following 12 months, and in the lifetime for the defaulted portion of the portfolio. Therefore, provisions will be higher and more stable through economic cycles.

The same stability should occur to regulatory capital requirements, which cover the unexpected losses in the portfolio during the lifetime of contracts. If the proposal is implemented as currently designed by the Committee, regulatory capital requirements will tend to increase during stressed periods, creating undesired pro-cyclical capital treatment.

In addition, since provisions and regulatory capital requirement compose the “total required Shareholders’ Equity”, the IFRS 9 rule of lifetime provision for defaulted exposures will already demand banks to increase Shareholders’ Equity during stressed periods.

Credit Risk Mitigation (CRM) Framework Modifications

We strongly disagree with the removal of internal models for exposure calculations under the SA. We appreciate the improvement of exposure calculations for SFTs but we have reservations about implementing a CEM-type approach for SFTs that have been replaced for derivatives as deemed not risk-sensitive enough. The question of exposure calculations for SFT transactions needs to be assessed holistically taking the BCBS proposals on minimum haircuts into consideration. We agree with the reintroduction of external ratings to determine haircuts of debt instruments but still believe that the proposed haircuts are overly conservative.

Additionally, as part of the review of the CRM, we are pleased the Committee is reviewing whether this could affect banks’ recognition of netting with counterparties and specifically whether, and how, resolution regimes may affect the eligibility for CRM purposes of bilateral netting agreements covering repo-style transactions. We believe this point should not be an issue, as resolution regimes implemented in line with the key attributes should not affect netting agreements. In the EU, the BRRD contains explicit safeguards in this respect.

We propose to re-evaluate the 20% floor for risk weights on the collateralised portion of exposure especially in case of gold as eligible collateral particularly when this item must be revalued with the minimum frequency of six month. In our opinion, it should be in accordance

with the Comprehensive Risk Methods (CRM) (for the reference, please see the simple approach which is paragraph 132 in the second consultative document).

Please give our concerns due consideration.

Yours sincerely,

Dr. Franz Rudorfer
Managing Director
Division Bank and Insurance