

ABI response to
the 2nd BCBS consultation on
the revision of the CRSA

Introduction

We deeply appreciate that the Basel Committee has issued a second consultation paper on the revision of the standardized approach for credit risk and, in particular, that they have re-introduced the external ratings and put into question the treatment of some asset classes, as envisaged one year ago, that the industry had strongly opposed since they would have implied an increase of capital requirements without achieving the objective of more risk sensitivity and comparability. Besides some undeniable improvements, we take this opportunity to underline some criticalities and to remark a few key points:

- we are fully convinced that the standardized approach can be only complementary to **the IRB models** which **definitely remain the best option in terms of risk sensitivity** for banks which have been already authorized to their use by competent authorities. Shortcomings of internal models could be addressed directly through improvements in internal approaches themselves, or via existing regulatory tools. Recent initiatives such as benchmarking exercises and improvements to IRB assessment methodology may indeed help to directly address the Committee's concerns of RWA lack of comparability and high variability.
- the **Quantitative Impact Study (QIS)** launch in February is an appreciable opportunity to assess the potential impact of the present regulatory initiative and we deem also fundamental that the QIS results are then shared by the regulator to the advantage of the industry. However, being the consultation and the QIS deadlines not aligned, we are prevented from including QIS results in this consultation response and to strengthen our messages with proved evidence. Therefore, we would ask the Basel Committee to engage the industry even after the closing of the consultation period when the QIS outcomes are available and reconsider our arguments in light of potentially relevant issues arisen during the impact assessment.
- since the revision of the standardized approach for credit risk will inevitably coexists with the capital floor framework, these two initiatives can be effectively assessed only if considered jointly. Therefore, we deem important to stress the difficulties banks are facing in such an uncertain regulatory context and to which extent even commenting the present proposal becomes challenging without having more information on floors framework and their calibration. We hence ask the Basel Committee, which should finalize the new framework for credit risk by (presumably) September, to suspend it in order to align the completion of standardized approach and capital floors.
- As regards the **due diligence process**, it is stated that the analysis performed cannot ever result in lower risk weights than the ones assigned as 'base' risk weights with the external ratings. While we appreciate the value adding nature of the due diligence, that reduce the mechanistic reliance on external ratings, this provision basically frustrates any risk management effort made by banks to carry out an objective and accurate analysis.

- Moreover, institutions might actually have disincentives to perform the assessment on a best effort basis. It could be operationally burdensome and achieve even the opposite result in terms of comparability: in lack of strict 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 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. This would also help to address and to mitigate the proposed government support carve out that we see as very problematic in terms of current rating agencies disclosure, standards and methodological differences.
- **Specific issues are presented below following the order of the consultation document**

Sovereign exposures

ABI agrees that **sovereign risk** deserves a separate discussion once the CRSA is finalised. The ABI also suggest that any possible analysis of the sovereign risk should be done at global level.

Exposures to banks

1. The new consulting paper returns to the use of external ratings which is welcomed by the industry. However, the Basel 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. 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. Especially for smaller banks this requirement would be an undue burden. Moreover, if the due diligence test lead to a lower risk weight than the external rating the credit institution would still be obliged to apply the higher risk weight. **Therefore, we oppose to the proposed due diligence.**
2. 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.

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.

3. As far as the Standardised Credit Risk Assessment Approach is regarded, we deem that an enhanced **granularity** should be foreseen in the **proposed number of grades** and that lower risk weights should be provided, consistently with the 20% bucket envisaged in the *External Credit Risk Assessment Approach* (ECRA) approach. When in this case risk weight buckets apply, there should be a fourth bucket with a risk weight of 20%. In this regard, we would also like to be clarified on the rationale of the suggested levels of calibration.
4. Inconsistency between RW for BB+/B- rated banks (100%) and for unrated banks (in most cases, 50%)
5. The preferential treatment for **short term interbank** (less than 3 month) exposures should be kept in order to prevent a negative impact on market liquidity in interbank markets. ABI proposes that:
 - a) The minimum rating requirement should not apply for exposures with less than 1 month to maturity; in other words, for these exposures, both under ECRA and SCRA, a 20% RW should apply irrespective of the rating of the counterparty and the related sovereign rating;
 - b) 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.
6. The Committee should also review the risk weight assigned to interbank exposures with a **maturity longer than 3 months**:
 - a) The current approach is **overly conservative** considering the low default experience of banks which are, after the crisis, much stronger in terms of capitalisation. As highlighted by the recent Basel III monitoring exercise report¹, larger International banks have already made major progress in recapitalization and the capital shortfall has been significantly reduced during the last years;
 - b) As the proposal currently stands the same bank with the same rating would be assigned a risk weight for these exposures that more than doubles the one for short-term interbank exposures. In our opinion there is no fundamental reason for such a gap and it should be narrowed by pulling down the risk weight proposed for longer-than-three-month interbank exposures.
7. Given that the risk profile of covered bonds is quite different from the risk profile of the issuing bank, separate risk weights should be assigned to covered bonds, reflecting the historically low level of losses in the covered bond market. Firstly, it is to be acknowledged that covered bonds are governed by specific legislation that fulfils a number of strictly defined criteria. Secondly, covered bonds are particularly important for banks as they are eligible for liquidity reserves in respects of prudential liquidity requirements (the LCR). It is important that the cost of carrying large liquidity reserves are not unduly high, which

¹ <http://www.eba.europa.eu/documents/10180/950548/CRD+IV++CRR++Basel+III+monitoring+exercise+report.pdf/f414a01e-4f17-4061-9b88-4e7fb89cc355>

they likely would become if covered bonds exposures are treated as other bank exposures. Thirdly, while the covered bonds play a very significant role in the European financial system, similar markets are also developing on outside Europe, thus calling for a global stance. In our view it is very important that covered bonds issued by a credit institution in jurisdictions with specific covered bonds legislation that fulfils certain strictly defined criteria, may continue to have a preferential risk weight treatment.

8. Moreover, under the current set-up the floor would apply only in case the country is sub-Investment Grade. In practice, it would flatten the risk weight to 100% and make the grading unnecessary, apart from the identification of stressed counterparts. From this perspective, in case a country-specific risk floor is considered it could make sense to have the grading under Standardised Credit Risk Assessment Approach (SCRA) be limited to Investment Grade countries (this would create a cliff effect that in any case is implicit under the current proposal).

Exposures to Multilateral Development Banks (MDB)

9. We strongly support the Basel Committee's proposal to differentiate the treatment of banks and MDBs and to keep the use of MDBs' specific external ratings for risk-weighting purposes, given the nature and characteristics of these institutions.

However, greater clarity on the treatment of credit risk mitigation from Export Credit Agency (ECA) and Private Insurance products should be provided. In particular, ECA credit risk mitigation techniques that meet the criteria of an eligible guarantee should be equally effective regardless of the form in which the CRM technique is articulated, whether as a guarantee or as an insurance product.

In addition, we believe that Private Insurance should be explicitly recognised as an eligible credit risk mitigation technique (subject to meeting the criteria of the personal guarantees). This inclusion would be useful for the sake of clarity given that it was already acknowledged in the QIS Frequently Asked Questions (as of 20 December 2002)².

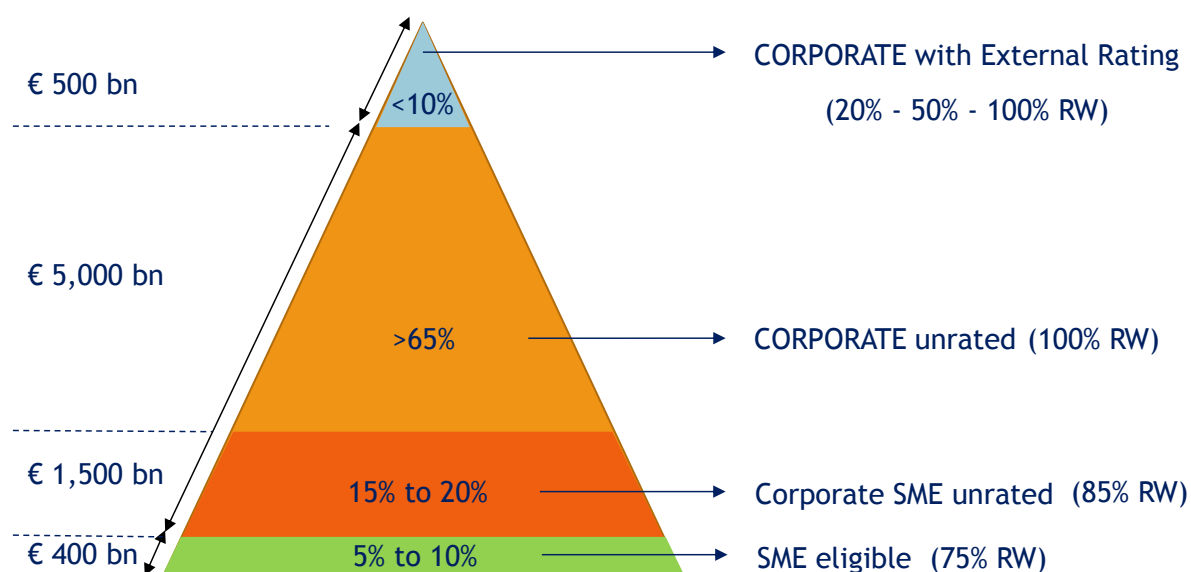
Exposures to Corporates

10. The recognition of external ratings is an improvement over the first consultative document because it contributes to a higher degree of achievement in the 3 objectives of the Committee:

- a) It enhances risk sensitivity at least for rated counterparties;
- b) It promotes comparability;
- c) It does not add complexity.

11. Therefore, ABI welcomes the re-introduction of external ratings for all the benefits they bring. Nevertheless, the coverage of external rating agencies for corporate counterparties is quite limited. The range of borrowers from SME to large corporate is very wide. According to EBF estimates and using EBA data the distribution of exposures across all types of corporates and SMEs in Europe looks approximately like this:

² <http://www.eba.europa.eu/documents/10180/950548/CRD+IV++CRR++Basel+III+monitoring+exercise+report.pdf/f414a01e-4f17-4061-9b88-4e7fb89cc355>



The fact is that less than 1% of the counterparties and only about 10% of the total exposure is externally rated. Therefore, there is a wide segment of mid-cap companies that do not have an external rating and do not qualify as eligible under the definition of corporate SME. This segment accumulates around two thirds of the total bank exposure to European companies. A 100% risk weight would restrict mid-sized corporate business, the driver of the whole economy, which is already penalised vis-à-vis other asset classes by the liquidity requirements. It is thus imperative to put in place a solution that assigns a 75% risk weight to exposures to unrated corporates that comply with the conditions set for the category of investment grade in the Standardised Credit Risk Assessment Approach (SCRA);

12. We also appreciate that within the new revised approach a risk weight of 85% for unrated exposures to corporate SMEs has been proposed. This reduces the 'cliff effect' that the former approach is likely to entail in the case of SME exposures falling out of retail portfolio. At the same time we think that the combined effect of the: (i) 85% risk weight for unrated exposures to corporate SMEs and (ii) 0,2% 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).
13. The **RW of corporate SME** should be lower than the proposed 85%. ABI proposes a 75% limit instead of 85%.
14. The risk weight applied to BBB+ to BBB- corporates should be revised and lowered in order to adequately reflect the credit quality of the counterparty. Indeed, it is proposed the same risk weight for a BBB+ investment grade corporate as for a BB- corporate which is non-investment grade. The gap in terms of credit quality between the both is significant as the first has much better credit quality than the latter, as it is also reflected in the proposed tables for MDB exposures and banks.

15. For a better alignment between the Standardized and IRB approaches, the special treatments already provided for purchased receivables under IRB systems should be extended to the Standardized approach, in particular allowing:

- a) the possibility to apply the risk weight of the debtor when operational requirements for purchased receivables are met (see §493 and following of the International Convergence of Capital Measurement and Capital Standards paper by the BCBS and art. 184 of the CRR), accordingly to the top down and bottom up approaches;
- b) the possibility to apply the facility level approach for purchased receivables as well, extending the application of §76 of the current consultation paper as follows: "For retail exposures and purchased receivables, the definition of default can be applied at the level of a particular credit obligation, rather than at the level of the borrower. In the case of purchased receivables, every invoice is considered as a single credit obligation."
- c) a preferential risk weight for exposures to unrated corporations of 75% instead of 100% when assisted by purchased receivables, in order to recognize the lower LGD of the operations guaranteed by purchased receivables³, as already provided for the IRB Foundation approach (LGD of 35% instead of 45%), when the requirements are fulfilled.

We believe there is no actual reason why such approaches should not be extended to the SA. Recognition of the lower risk of purchased receivables is consistent with the aim to make the SA a valid and effective alternative to the IRB, and also to the aim to avoid adverse selection that may push to more risky financial alternative in the absence of a correct calibration of the risk of exposures related to purchased receivables.

16. For purchased receivables that are assisted by a credit insurance contract, to provide a lower risk weight under the Standardized Approach taking into account that the historical LGD for insured receivables is not 45% but rather 35%, i.e. by applying a reduction factor of, for example, 0.75, to the applicable risk weight.

Specialised Lending (SL)

17. With respect to the first consultation paper, we do not see any significant improvement and this asset class remains among the most negatively affected, while it should definitely be the opposite: the capital burden should be cushioned to encourage the relaunch of the real economy.

Furthermore, a flat risk weight approach for this asset class is disputable: specialized lending initiatives are tailored-made and tend to differ even significantly one another. The

³ The lower risk of factoring and commercial finance products, typical products where purchased receivables are involved, has been recently confirmed by a comparison at European level to traditional banking by the EUF in the White Paper on the factoring and commercial finance industry (2016).

Basel Committee is expected to take into account the peculiarities of this segment and opt for a more granular approach. In this regard, risk weights should be influenced by related guarantee structures: project and object finance are frequently highly collateralized, hence mitigating the counterparty's default risk. If the Basel Committee aims at enhancing the risk sensitivity, collaterals cannot be completely disregarded. It is worth to mention moreover that it is unwarranted to have a higher risk weight for properly collateralized SLE than corporate assets even unsecured.

18. To ship loans apply SL regulation although these loans have specific characteristics that make these exposures sounder than those generally considered in the SL framework.

Ship loans fulfil conditions set in paragraph 50 for real estate exposures. In particular:

- ship loans are guaranteed by first line shipping mortgages with an LTV generally well below 80%
- quality of the guarantees is good. The ship secondary market is sound and liquid. On average every year are commercialised on the secondary market a percentage between 6% and 10% of the ships world wide
- ship loans are more granular and less volatile than commercial real estate loans.

Ship loans guaranteed by first line shipping mortgages should be weighted as commercial real exposures fixing risk weight according to the LTV. Risk weights considered in tables 11 and 12 could be applied based on whether the repayment is materially dependent on cash flows generated by property or not.

Retail portfolio

19. We appreciate that the new consultative document **introduces a definition of SME (reported sales for consolidated group less than €50 million)**. Exposures to SMEs where personal guarantees are given should qualify as part of the regulatory retail portfolio.

20. 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.

21. This can entail significant drawbacks; in particular the specific business model of small banks – informally-intensive and traditional lending activity (so called relationship lending) – might be negatively affected by the prudential regulation mainly for a twofold reason:

- 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.
22. 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.
 23. **We believe that the granularity criterion should be maintained as a qualitative requirement** and national discretion should be allowed to detail it. Otherwise, a granularity threshold of at least 2% would be needed.
 24. 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.
 25. 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.
 26. **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.

27. We consider that the risk weight for retail exposures is not risk sensitive and excessively punitive for good quality portfolios. Therefore, the proposal could have unintended consequences as it would lead to a misrepresentation of the risk level and, subsequently, provide incentives for lower quality portfolios and inhibit the lending to the real economy. As a solution, we suggest to increase the granularity of the risk weights 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. As a consequence, the capital requirement should increase with maturity.

- The presence of physical collaterals. We believe that the framework should recognise the risk mitigating arrangements included in certain retail transactions, such as leasing and loans collateralised by durable goods (e.g. reservation of title in financing vehicles) . Deloitte research “The Risk Profile of Leasing in Europe: The role of the leased asset” demonstrates that default and loss rates for leases are significantly lower than for traditional lending. According to the latter study, which was based on a portfolio of 3.3 million lease contracts in 15 European countries, one-year defaults on leasing Retail SME exposures were 2.7% compared to 4.5% for all Retail SME lending in 2010. Similarly, Loss Given Defaults for leasing were 19.6% compared to 33% for all Retail SME lending.

28. With reference to **specific products** that have different risk characteristics, compared with other retail exposures, we propose a specific supervisory treatment for Salary Secured Loans and Pension Secured Loans (Cessione del quinto dello stipendio/pensione).

In Italy, these loans are governed by Presidential Decree 180/50 (and subsequent amendments and additions), by the related enabling Presidential Decree 895/50, and by various instructions from the Ministry of the Economy and Finance and the Bank of Italy on the proper implementation of the regulations.

This technical form of consumer credit is supported by a series of guarantees that reduce the credit risk in comparison with other forms of retail loan.

These guarantees include:

- (i) direct assignment of one-fifth of the pension or salary to cover payment of the loan instalments;
- (ii) 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);
- (iii) transfer of the effects of the assignment of salary to the pension when the borrower retires;
- (iv) restrictions on access to the retirement bonus (trattamento di fine rapporto – TFR) and/or similar indemnities, with immediate recourse available to the creditor;
- (v) restrictions on possible attachments and seizures of the salary/pension that guarantee the privileges of the lender in comparison with other creditors.

Salary Secured Loans and Pension Secured Loans 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 survey⁴ carried out by EBF 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%⁵
- the expected loss (EL) is 0.16%.

In view of this evidence, it is requested that Salary Secured Loans and Pension Secured Loans be recognised as less risky than retail portfolio loans and deserve a much lower RW than the current RW for the retail portfolio (75%). We suggest that an appropriate RW should be set in 35%.

Residential Real Estate

29. ABI supports the option of **Loan Splitting (LS) versus Whole Exposure (WE)** in the allocation of Exposure At Default (EAD) to Loan To Value (LTV) buckets. It can be argued in favour of LS that:

- It avoids cliff effects as marginal increases in LTV would lead to disproportionate increases in RW;
- There is an undesirable incentive to split the loan between different entities in case that the LS option is not recognised.

30. The loan splitting also better reflects the risk associated with junior liens as the risk weight of higher LTV bands increases accordingly.

31. The comparative risk weight across asset classes gives way to counterintuitive cases. For instance, exposures collateralised with residential real estate (where repayment is materially dependent on cash flows generated by the property for commercial and residential real estate) with LTVs above 60% have a risk weight ranging between 90% and 120% whereas unsecured retail exposures have a risk weight of 75%. We suggest to take into account the risk weight of the counterparty as the maximum risk weight applicable for exposures secured by real estate.

32. All in all, we need to make a proposal for a **phase-out period** on the basis that the impact on current borrowers should be limited and banks should be given enough time to adapt their lending conditions to the new rules.

Commercial Real Estate

33. Also for commercial real estate we ask to adopt the option of **Loan Splitting (LS) instead of the Whole Exposure (WE) option** in the allocation of Exposure At Default (EAD) to Loan

⁴ Eleven of the twelve intermediaries referred to in note 2 participated in the survey described below, providing over 80% coverage of 2013 loans guaranteed by the assignment of one-fifth of salary or pension.

⁵ The weighted-average LGD rate was provided by a sub-sample of 7 respondents.

To Value (LTV) buckets. A specific analysis conducted on the (not residential) real estate leasing market demonstrates that:

- the total RWAs resulting from the application of the Whole Exposure (WE) rule would be disproportionate as respect to the total RWAs that would result by applying the IRB approach to the same contracts;
- total RWAs resulting from the application of the Loan Splitting (LS) rule would still be more prudential than those resulting from the application of the IRB approach.

34. In its current proposal, the BCBS strongly penalises commercial real estate exposures. There is a poor recognition of the mortgage-enhanced security. Real estate secured exposures appear to be treated as a separate asset class. It is in fact hard to reconcile the discrepancies in the risk weights across classes of exposures. 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.
35. It is important to highlight that commercial properties represent important credit risk mitigation instruments for SMEs.
36. 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

37. **Small scale home builders** deserve a distinct treatment as the risk profile is significantly lower than that of speculative building development.
38. The proposal for mortgages where repayments are materially dependent on cash flows generated by the property and ADC (Land acquisition, development and constructions) exposures will significantly increase the capital requirements, impacting on the cost of this lending and therefore on the ability of the banking sector to provide credit. We consider that these products are unduly penalised and capital levels go significantly beyond the risk incurred by these products:

The Basel Committee proposal strongly penalizes the development of the real estate market in terms of Land acquisition, development and construction (ADC) exposures. According to this proposal, these kind of exposures are classified with the same risk weight of “defaulted exposures”. The adverse consequences of this proposal could reduce the capability to grant these loans, with a general increase in interest rates affecting borrowers and indirectly also affecting their creditworthiness, in terms of the sustainability of instalment payments. 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

Risk weight add-on for exposures with currency mismatch

39. We do not agree with the proposed risk weight add-on for exposures with currency mismatch. We believe that the proposal could have asymmetric effects. The impact will be different across jurisdictions and at different points in the economic cycle:

- a. It is acknowledged that there is a potential increased risk of the customer defaulting due to adverse foreign exchange rate movements between the currency of the borrower's loan and the currency of the income of the borrower (i.e. if the currency of the income depreciates against the currency of the loan). Indeed, this could lead to a depreciation of the borrower's income and subsequently could lower the borrower's ability to repay the loan to the bank. However, there might be situations where the currency of the borrower's income appreciates against the currency of the loan and this actually might decrease the customer's risk of default. We therefore believe that this situation should be considered in the proposal.
- b. The proposal does not recognise a proportionate approach with regard to the add-on. For instance, if a corporate earns its main revenues mostly in a given currency (for instance Euro), any loan in a different currency whatever the amount of the loan will be subject to this risk weight add-on. We consider that the proposal should include a proportionate approach when imposing the add-on commensurate with the size of the lending exposures.
- c. The add-on could have a relevant negative impact in emerging economies. We consider that the proposal should take into account that companies from the many "dollarized" economies can transfer this currency risk to their customers and suppliers.
- d. The proposal is not risk sensitive. We suggest to calibrate the add-on according to the residual maturity of the operation. In this respect, we propose to short term loan not to be subject to an add-on, medium term transactions with a reduced add-on and long term transactions the proposed 50% add-on.
- e. As EU/EES integrates it becomes increasingly common that households own a property situated in a country with another currency than the currency of the household's income. This could for instance be the case with families living close to borders between countries in EU/EES with different currencies and having their home on one side of the border and earning their income on the other side of the border⁶. Another example is when families have a vacation house in another country than in that where it earns its income⁷. In many of these cases it is common that if the property is financed with a mortgage loan, that loan is denominated in the same currency as that of the country where the property is situated. This practice has developed because the financing banks deem it too risky to provide a mortgage loan in a different currency than the currency of the country where the property is situated. This is because history tells us that from time to time exchange rates may

⁶ This is, inter alia, common in the Danish-Swedish Örestad region around the Öresund bridge between Malmö (Sweden) and Copenhagen (Denmark), along the Swedish-Norwegian border along the Swiss-EU border and along the eastern border of the Euro zone or when people (e.g. construction workers) are working abroad on a semi-temporary basis earning their income in a different currency than that of their home country.

⁷ E.g. British citizens having a vacation dwelling on the continent or German or Danish citizens having a cottage in the southern part of Sweden.

change significantly within a short time period without having much impact on property prices.

In order not to punish banks from applying this from a risk management sound principle the add-on for loans denominated in another currency than that of the borrower's income should not be applied on mortgage loans where the loan is in the same currency as that of the country where the property taken as collateral is situated. We therefore propose that the wording of paragraph is changed in the following way:

63. For the purposes of paragraph [62], unhedged exposure means an exposure to a borrower that has no natural or financial hedge against the foreign exchange risk resulting from the currency mismatch between the currency of the loan and the currency applied to pay down the loan. A natural hedge exists where the borrower, in its normal operating procedures, receives foreign currency income that matches the currency of a given loan (e.g. remittances/export receipts) ***or if the exposure is secured with a property located in the country having the currency of the loan as its national currency.*** A financial hedge generally includes a legal contract with a financial institution (e.g. forward contract).

40. We are concerned about the statement that “the existence of Currency Mismatch should be part of the global assessment through the due diligence” because:

- f. This means that banks will have to check, for each facility, that there is no currency mismatch, even if the borrower is established in the country of the currency of the loan: from an operational point of view this will be highly burdensome.
- g. It does not introduce any proportionality: If a corporate has its main revenues, but not all, in a given currency, it means that any loan in a different currency, whatever its size will be subject to additional risk weight.
- h. A loan in USD to a counterparty whose main revenues are in EUR will be subject to an additional RW, a loan in EUR to the same counterparty who convert the amount in USD will have no additional RW while the risk is the same for the lender. Such additional requirement will induce an increase of the financing cost for middle market corporate that need to borrow foreign currency to develop their activity in new foreign markets where they do not have yet existing revenues. The corporate customer can have many other FX exposures under other means than loans in currency mismatch.

Treatment of past due

- 41. The risk weights of defaulted exposures is proposed to be increased due to a perceived double benefit for the current risk weight (lower exposure amount and lower risk weight). The guiding principle for which risk weight is correct for an asset is the inherent risk in the cash flow. Assets with less certain cash flows should have higher risk weights and vice versa.
- 42. There is no double benefit in the current risk weight, due to the effective write down, in acquired defaulted exposures. Trades of defaulted exposures are done on a relatively

active market, typically in auction like settings. Acquirers are often, but not always, non-regulated debt collection companies. The net booked value of defaulted exposures include the value of the asset, as well as an acquisition margin and the effective write-down.

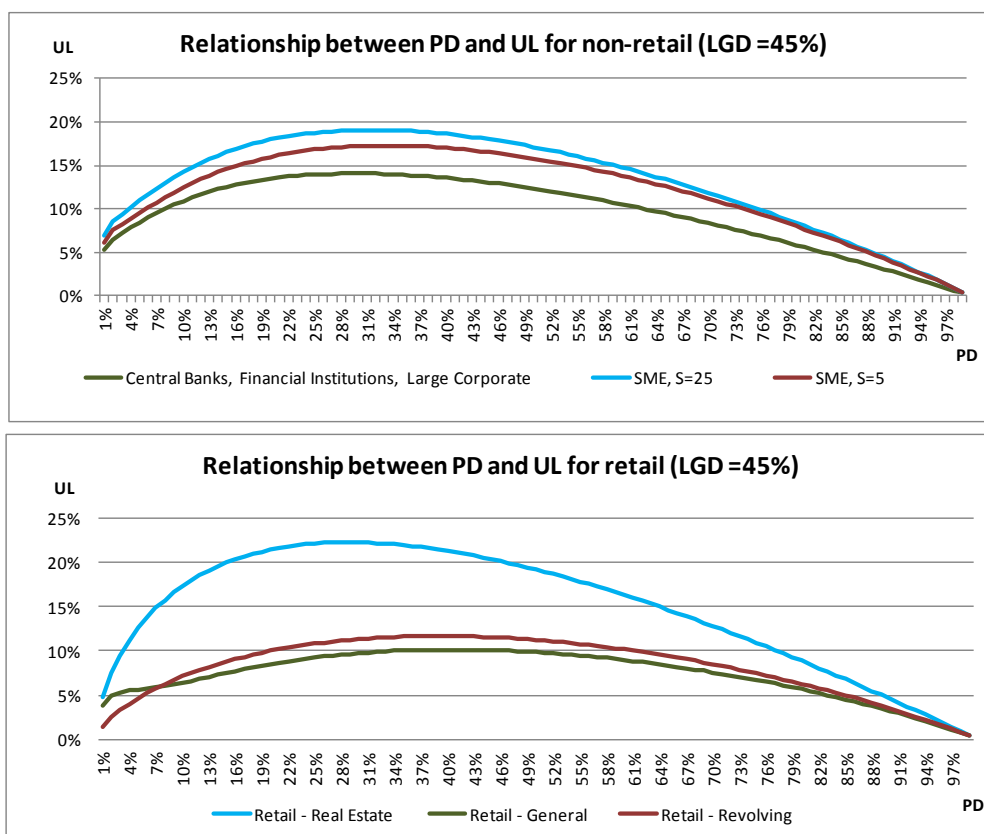
Nominal amount = Asset value + acquisition margin + effective write down

43. Is there a difference in risk between performing credits and acquired defaulted exposures? Thorsell⁸ finds that there is an excess return on defaulted corporate bonds, meaning that a portfolio of corporate bonds, after re-valuation have a higher return than can be explained by their riskiness. I.e. he finds that defaulted corporate bonds typically trade at a discount, and is less risky than could be expected. Furthermore, the difference in market beta between ex-post non-defaulted bonds and defaulted bonds are insignificant in the GARCH (1,1)⁹ specification (0.0855 vs 0.0843). This means that the asset quality for an acquired defaulted exposure is similar to a corporate credit, and should have a similar risk weight.
44. The threshold level of at least 20 percent in provision, write down or acquisition margin for a lower risk weight (100% instead of 150%) in the current standardised approach for credit risk can still be relevant as a threshold level for acquired defaulted exposures meaning that the Asset value in above formula can be maximum 80% of the Nominal amount, since that is an indicator of a sound buffer for unexpected losses.
45. The IRB capital requirement formula is based on a very important principle: The capital requirements reflect the unexpected loss through the deduction of the expected losses from the VaR estimate (with a confidence level of 99,9%).

Based on that and starting on a specific inflexion point, when the PD increases the capital requirements start to decrease as the expected loss is already high, “leaving” less space for substantial unexpected losses. This can be observed in the following illustrative graph:

⁸ Thorsell, H. “The Pricing of Corporate Bonds and Determinants of Financial Structure.” PhD Dissertation, EFI, Stockholm School of Economics, 2008.

⁹ The GARCH (1,1) specification is the relevant comparison since it lessens the impact on the estimate from the default itself.



This principle is also acknowledged in the assessment of the risk weight formula for exposures with a PD = 1 (defaulted exposures): $RW = \max(0; 12,5 * (LGD - ELBE))$.

In this case, being ELBE an approximation of the impairment provisions (if not, any positive difference would be deducted to CET1), there is a strong incentive to include stressed macroeconomic conditions on impairment calculations (as already proposed for IFRS 9 purposes and also on CP/2015/36 by EBA) in order to minimize the difference between the LGD (of defaulted exposures) and the ELBE estimate.

In summary, all IRB framework is constructed in a principle that for defaulted or quasi-defaulted exposures (higher PD), the capital requirements are reduced as they represent unexpected losses that, from a specific point, start to decrease as the expected losses increase. However, although is acknowledge by BCBS the need to align both frameworks in page 17 ("From past due to defaulted exposures"), the proposed exclusion of the provisions as a driver for the standard RW will create an inconsistency between STD and IRB frameworks, which will originate again a departure from the IRB framework.

In conclusion, provisions should be considered when determining the risk weight.

46. Since the Basel Committee is currently involved not only in the revision of the standardized model for credit risk, but also of the IRB, we would recommend the regulator to **reassess the risk weights for defaulted exposure after the review of the internal models** in order to calibrate them in line with the considerations done for the IRB: this would firstly preserve unique and flat risk weights, achieving the desired level of simplicity, would enhance the comparability across banks and could probably result in lower and hence more realistic level of risk weights.

47. In case the above proposal was not taken on board by the BCBS we suggest that:

- an article is added after paragraph 76 like this:
xx. For acquired defaulted exposures where the asset value (net booked value) is equal to or lower than 80% of the remaining nominal exposure amount shall be risk-weighted at 100%.
- paragraph 77 is changed to:
77. With the exception of acquired defaulted exposures under paragraph [xx] and real estate exposures treated under paragraph [78], the unsecured or unguaranteed portion of a defaulted exposure shall be risk-weighted net of specific provisions and partial write-offs at 150%.

48. We propose to amend §75 adding the following to the first bullet point: *"Any material credit obligation is past due more than 90 days or 180 days for purchased receivables to Sovereign and Public Sector Entities. Overdrafts will be considered as being past due once the customer has breached an advised limit or been advised of a limit smaller than the current outstanding. Purchased receivables will be considered as being past due once the expected payment date has passed, unless there is evidence that the delay of the payment is due to commercial reasons other than financial difficulties of the buyer (i.e. disputes, payment flexibility, reconciliation processes, verification procedures etc...)"*.

Off-balance sheet items

49. We believe that the proposed treatment for off-balance sheet items contradicts the Basel Committee's message that "increasing overall capital requirements under the standardised approach is not an objective". In particular, the proposal to increase the CCF (from 0% to 10%-20%) for commitments that are unconditionally cancellable unduly penalises these **retail** exposures.. We therefore suggest maintaining the current CCF of 0%. **Corporate** unconditionally cancellable commitments (UCC) are excluded from the preferential treatment set out in paragraph 69 of the consultation document. Given the evidence from first QIS on 2014 consultative document (*"the average CCF estimated under Advanced IRB for unconditionally cancellable commitments is higher than the proposed (10%) CCF, although there were large variations between countries"*), a different treatment between corporate and retail UCC is not justified. In ABI's opinion UCC to corporates should be applied the same CCF as retail UCC..

In case the above proposal were not accepted we could agree a 10-20% CCF on retail if (and only if) the CCF for corporates was calibrated at the same threshold as for retail (as suggested in the first CP)

50. 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:

- a. 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.
- b. 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.

51. Additionally, we have the following opinion related to CCF for trade finance:

- c. A CCF of 20% should be applied to short-term self-liquidating trade letters of credit arising not only from the movement of goods but also from the movement of services. We suggest including this possibility in paragraph 68 of the proposal
- d. The CCF associated with trade related guarantees should be reduced to 20% in order to appropriately reflect the risk. This is supported by a case study published by the ICC Trade Register in 2014.

52. We propose to change §68 as follows: "A 20% CCF will be applied to both the issuing and confirming banks of short-term self-liquidating trade letters of credit arising from the movement of goods (e.g. documentary credits collateralised by the underlying shipment) as well as for factoring and invoice finance commitments that are unconditionally cancellable at any time by the bank without prior notice, or that effectively provide for automatic cancellation due to deterioration in a borrower's creditworthiness." Factoring and receivables finance indeed have a short term and self-liquidating nature and can be assimilated to trade finance.

53. 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*: Thus should one consider that a UCC is a commitment?

54. Moreover, due to the accounting framework (this is the case for IFRS jurisdictions), commitments that are cancelable at any time without conditions, without prior notice do not appear in the accounting reporting: Should Banks continue to align their risk perimeter on the accounting reporting and thus ignore those commitments?

55. The concept of UCC has been introduced by the Basel 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 Basel Committee has decided to apply a CCF different from 0%, the BCBS should clarify what is a commitment and what is not a commitment in the banks' practices.

56. In particular, we would recommend splitting retail category in two, distinguishing individuals from small business, introducing a lower CCF for the latter whose credit exposure is well monitored within the internal risk management process.

57. *In conclusion, this proposal could be particularly penalizing whereas the risk is well monitored via bank's internal process. For instance, Italian firms utilize widely self-liquidating facilities that the bank grants after having certified the credit quality of the third party obligor.*

Equity and subordinated debt

We believe that a distinct treatment for the banks and corporates should be recognized, taking account of some features laid down by prudential regulation for the banking issuers and, more in general, of the different risks underlying.

These distinct treatments could be substantiated, for instance, as the recognition of a 100% RW to the regulatory capital instruments (CET1, T1 and T2 instruments) issued by a bank respecting minimum capital requirements and MREL indicator. In particular, a 100% RW should be recognized, by virtue of the fact that the issuer of the instruments is a bank already compliant with capital prudential and resolution requirements.

Regarding the equity exposures, we believe that the approach would be unduly penalizing: the most conservative 250% risk weight had been only introduced to avoid/limit the risk of “double gearing” (i.e. where the same capital is used simultaneously as a buffer against risk in two or more legal entities, hence allowing them to increase the overall assets volumes without proportionally increase capital). This risk, which can result in an increased systemic risk on markets, interests only significant Financial Sector Entities (FSE). Hence the proposal to envisage the same treatment for all equity exposures including non-financial entities would not reflect the underlying risk.

Referring to exposures in equity issued by corporates it is also worth to mention that the approach laid down risks having severe impacts on the ability of the banks to support the economy. Especially in Italy where industrial companies have frequently been complained for their low level of capitalization, equity investments by banks (but also insurance companies, pension funds et al.) have played a crucial role in strengthening firms capital, making them more solid and competitive on domestic and cross-border markets. Moreover, the penalizing treatment that these exposures have according to recently amended accounting principles has already lowered investments. Additional and uneven capital requirements will have a direct impact on the relaunch of the real economy.

For this reason we propose to restore for the equity exposures related to corporates the risk weight at 100%

Exposure to securities firm and other financial institutions

58. 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.

Credit risk mitigation (CRM) techniques

59. The point was made that collateral in **auto-loans** and consumer credit has a value and could be computed for CRM purposes. It seemed to be a weak case at first sight, but it could gain recognition if well elaborated by members. My suggestion is to separate types of guarantee: Consumer credit like white-line (e.g. washing machines) is a very weak case, but auto-loans could be defended. It is a significant portfolio across the EU and there must be data available from banks and carmakers industry.
60. The **eligibility of UCITS for CRM** purposes should be included.
61. The new standardised approach for measuring counterparty credit risk exposures includes the collateral posted in the EAD formula and therefore these guarantees, cash or securities, are not subject to credit risk charge. Even the formula for calculating the EAD for SFT with GMRA (Par. 164) recognizes the side in both directions, received and paid. For these reasons we ask to delete the phrase "as will the posting of securities in connection with derivatives exposures or with any other borrowing transaction" in paragraph 129 of Annex 1.
62. We ask to clarify the scope of application of the paragraph 146 in Annex 1. In our opinion it should be applied to transactions which not generate counterparty credit risk. Indeed in this formula "C" is equal to the current value of the collateral "received", while the collateral is considered in both directions to calculate the EAD for counterparty credit risk.