March 27, 2015

Secretariat
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002
Basel, Switzerland

Re: Revisions to the Standardised Approach for credit risk

Ladies and Gentlemen:

The Bankers Association for Finance and Trade (BAFT) is an international financial services trade association whose membership includes a broad range of financial institutions throughout the global community. As a worldwide forum for analysis, discussion, and advocacy in international financial services, BAFT member banks provide leadership to build consensus in preserving the safe and efficient conduct of the financial system worldwide.

BAFT appreciates the opportunity to comment on the proposal published by the Basel Committee on Banking Supervision ("Basel Committee" or "the Committee"); entitled *Revisions to the Standardised Approach for credit risk* ("Consultative Document" or "the proposal").[1] BAFT welcomes the work of the Committee, through the Basel framework, in promoting a more resilient banking sector and we agree that a strong banking system is the foundation for sustainable economic growth. As BAFT represents the transaction banking segment of financial institutions globally - including the trade finance and cash management business lines - we are particularly concerned, however, about the impact that new regulatory initiatives could have on the provision of these crucial financing services. To that end, BAFT's comments on the proposal are primarily focused on issues for these particular sectors of the banking industry. Our comments should also be read in conjunction with the Committee's review underway on the consultation entitled *Capital floors: the design of a framework based on standardised approaches* ("Capital Floors Proposal"), which, when taken in total, will have significant effects on the provision of transaction banking globally. [2]

Introduction and Main Themes:

BAFT supports the objectives of the Basel Committee in the reform of the international financial services sector and we believe a great deal has been accomplished through the design and implementation of the Basel III capital, leverage and liquidity standards. We applaud the Committee for their careful consideration of the economic impact of these rules globally and we look forward to further dialogue with the Committee as these standards are reviewed in order to avoid possible unintended consequences for the real economy. In the context of the Standardized Approach consultation, however, we have material concerns around the implementation of a new approach to credit risk given the complexity and timing of the other regulatory changes from the Committee alongside regional and national proposals to implement those changes. The Basel standards must be implemented consistently and in a way that allows the market to adjust to their use. As such, we would suggest a more studied approach to market reaction upon implementation of the full basket of prudential regulatory revisions agreed thus far before moving

[1] Basel Committee on Banking Supervision: *Revisions to the Standardised Approach for credit risk;* December 2014

[2] Basel Committee on Banking Supervision: *Capital floors: the design of a framework based on standardised approaches;* December 2014

forward with the wholesale revised implementation of the Standardized Approach, as this reassessment will ultimately have a broader impact on how other regulatory regimes work in practice. This suggested way forward will in turn help mitigate unintended impacts for the marketplace and allow for more considered analysis of the most effective method to ensure enhanced granularity and risk sensitivity in the Standardized Approach, along with more comparability with the internal ratings-based (IRB) approach.

BAFT also has concerns not just with the structure and timing of the proposal but with some of its suggested revisions. The proposal, as currently designed under the Consultative Document, could lead to potential negative effects outside the scope of the Committee's intentions. For example, though the Committee states that increasing overall capital requirements under the Standardized Approach for credit risk is not an objective of the consultation, the proposed changes indicate that capital requirements would indeed increase, particularly for high quality portfolios. The proposal calls for the lowest risk weight for both bank and corporate exposures to increase and for the credit conversion factors (CCF) for unconditionally cancellable commitments and other commitments regardless of maturity to also rise. This could lead banks away from incentivizing high quality financial products in favor of other types of lending. In addition, risk sensitivity in the approach could be damaged by the proposal as it currently stands. This is particularly true for bank and corporate exposures where external ratings are replaced by an approach that only looks at two risk drivers. In some cases, this level of review will not adequately assist in identifying risk that is better captured by the more structured approach of external credit ratings. Lastly, the proposed framework specifically does not recognize the differentiated treatment accorded by the Basel Committee to low risk profile asset categories such as trade finance under the Leverage Ratio and Liquidity Coverage Ratio (LCR). Failing to recognize this differentiation will have the effect of diverting capital resources away from supporting trade flows and economic growth. [3]

In order to better assess these issues and promote a sound method of capturing and addressing credit risk, BAFT recommends that the Committee review the proposal in conjunction with a robust Quantitative Impact Study (QIS) to assess the adequacy and effectiveness of the suggested risk drivers. The Committee should also carefully examine how the revised Standardized Approach will interact with other regulatory standards, in particular, the Leverage Ratio, as the calculation of that ratio is dependent upon the Standardized Approach for off-balance sheet exposures. Lastly, we believe the Committee should adjust consideration of the timeline for finalizing the revised Standardized Approach to recognize the intricacy of amending one of the fundamental pillars of the Basel framework, along with the necessity for consideration of the time and processes involved in transposing the new regime into national regulations by the member states of the Basel Committee.

Taking into account the concerns and themes noted above, BAFT believes there are certain specific aspects of the proposals that should be considered now for revision by the Committee as review is underway. As such, we are grateful to submit the following comments on particular sections of the Consultative Document that have the most impact for the transaction banking industry.

[3] In particular, trade finance (which supports the import and export of goods and services globally) is a critical driver of economic growth in the real economy that should be differentiated from other exposure classes. Special consideration should be given when reviewing and altering the Standardized Approach to the low risk profile of these financial products. Since 2011, the banking industry, through the International Chamber of Commerce (ICC), has been collecting granular trade finance default and recovery data covering over 4.5 million transactions and totaling exposures in excess of USD 2.4 trillion. An analysis of this data outlines the extremely low level of losses that arise from this business, with transaction level default rates at 0.030%. (ICC; *Trade Register Report*; 2014) In addition, the Asian Development Bank's (ADB) 2014 Trade Finance Survey indicated that a 15% increase in access to trade finance would increase production by surveyed companies by 22%. Respondents also noted that a 15% increase in trade finance support would enable firms to hire 17% more staff, leading to a direct correlation between job growth and trade finance availability (ADB; *Trade Finance Gaps, Growth and Jobs Survey*; December 2014). We encourage the Basel Committee to take these factors into consideration when designing new regulatory regimes, such as the Standardized Approach, in order to ensure trade finance availability is enhanced and not inhibited.

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Key Recommendations:

1. Credit Conversion Factors (CCF) for Off-Balance Sheet Exposures

The Committee states that the two main weaknesses identified with regard to off-balance sheet exposures under the current Standardized Approach are (i) the outdated calibration of CCF, and (ii) the lack of consistency/comparability with the Foundation IRB approach. To rectify this, the Committee proposes that the CCF for unconditionally cancellable commitments should increase from 0% to 10%, and the CCF for other commitments, regardless of maturity, should increase from 20% or 50% (depending on the maturity) to a uniform 75%.[4]

The application of a blanket 75% CCF to commitments that are not unconditionally cancellable without taking into account the maturity factor of the commitments in question, we believe, is unduly punitive. While the 75% CCF has been proposed to conform to the IRB approach, since maturity is treated as a separate parameter within the IRB approach we believe maintaining the current distinction between commitments based on maturity would be more appropriate. Applying a uniform 75% CCF regardless of maturity would not be risk sensitive and is also not consistent with historical drawdown rates. In addition, the application of 10% floor for unconditionally cancellable commitments also should be revisited. A 10% CCF to commitments which are unconditionally cancellable at any time without prior notice, or that effectively provide automatic cancellation due to deterioration in borrower's creditworthiness, will require banks to put a cost on unconditionally cancellable commitments and to charge for those commitments or stop supplying them. This will lead to negative effects on the downstream users of these types of products, which is especially punitive as the proposed treatment is not consistent with the nature of these commitments as financial instruments. We believe a 0% CCF should be maintained for these exposures.

Though we note that no change has been proposed regarding the CCF for short-term self-liquidating letters of credit (LC) arising from movement of goods or the CCF for transaction related contingent items, BAFT believes that the current examination of the Standardized Approach presents an important opportunity to assess the CCF for the latter products that directly support the financing of international trade. BAFT believes the Committee should consider adjusting the CCF for non-financial guarantees and standby guarantees related to international trade from 50% to 20%.[5] Non-financial guarantees and standby guarantees connected to global commerce are essential products supporting cross-border movement of goods and services and their historical performance data substantiates a 20% CCF calculation. The International Chamber of Commerce (ICC) analyzed the default rate and conversion factors for performance guarantees, alongside performance standby letters of credit. Their low default rates and low rates of conversion on balance sheet enumerate the fact that these types of trade finance products present a low risk and conversion profile, particularly when compared with corporate loans.

[4] We note that even though the Committee states the desire to align the IRB and Standardized Approaches, there is no reason given why the IRB 75% CCF is more appropriate than the Standardized Approach CCF for commitments. Indeed, the Standardized Approach CCFs are in many ways more risk sensitive than the IRB approach and consideration should be given to amending the IRB approach to take this into account.

[5] Non-financial guarantees and standby guarantees include warranties (including tender and performance bonds and associated advance payment and retention guarantees) and guarantees not having the character of credit substitutes, along with irrevocable standby letters of credit not having the character of credit substitutes. These types of products should fall under the definition of transaction related contingencies to receive a revised 20% CCF, which should be clarified to include performance bonds, warranty bonds, advance payment guarantees and performance-based letters of credit and Standby LCs which guarantee the repayment of receivables or other amounts due arising from the sale of goods and services or other liabilities which arise from the sale of goods and services, including customs and tax bonds.

In particular, for a dataset of 494,117 transactions from 2008 to 2012, performance guarantees had an overall default rate of 0.027%, representing only 131 transactions.[6] The ICC also provides measures of the extent to which products do or do not convert on balance sheet: (i) the number of document sets rejected on first presentation; and (ii) the number of transactions that expire without payment. Expiries without payment are highly common on guarantee products, especially for performance guarantees, where the conversion factor in the data set analyzed was found to be only 13%.[7] This is understandable as this kind of product is used to protect against the unexpected lack of performance of the counterparty. In the vast majority of cases, the transaction is meant to proceed to successful conclusion and the guarantee is not meant to be utilized. As such, one finds a very small percentage of drawings or demands for payment under such instruments.

Through Capital Requirements Directive IV (CRDIV/CRR), the European Union (EU) already adjusted the Standardized Approach CCF for non-financial guarantees and standby guarantees to 20%.[8] By taking this step, the EU recognized the intrinsic nature of these products and their low rates of conversion on balance sheet. Harmonization of this treatment is very important across all jurisdictions of the Basel Committee. This will in turn assist in the financing of international trade by lowering the cost of providing these services to importers and exporters. Higher CCFs translate to higher capital requirements for banks and this has the direct implication of higher pricing for clients, even for low risk trade finance products. Increased pricing may lead to a lower number of clients utilizing such products and/or existing clients utilizing a lesser number of such products, which can lead to a reduction in trade flows globally.

Lastly, BAFT believes that the revision of the Standardized Approach presents opportunities for further clarification of terms to better help the industry interpret the application of the CCFs for off-balance sheet instruments and collect data on their drawdown rates. For example, the Consultative Document focuses on committed but undrawn amounts to determine CCF values. This raises the question as to whether 'commitments' is adequately defined and whether that definition could be inclusive of Standby LCs and trade finance related guarantees. The original Basel definition of commitment states that it is 'a future transaction that will result in a bank acquiring a credit exposure at some future date'.[9] The definition goes on to expand the nature of a commitment by outlining that, in some cases, the commitment is binding on the bank or will be invoked on a trigger event, and, in certain circumstances, there may be commitments which provide the bank with the flexibility to withdraw the facility. In addition, the definition also makes a distinction between revocable and irrevocable commitments. BAFT believes that it is clear from this definition that the focus is on facilities and not on Standby LCs or guarantees to the extent they are not facilities as covered under the definition of commitments. Consequently, reference to commitments in the context of determining CCF values for LCs and guarantees may be a case misinterpretation in the drafting of the definition. Standby LCs and trade finance related guarantees therefore should definitively fall within the definition of transaction related contingent items. Clarifying this within the draft text and amending the text suitably will provide greater certainty to market participants and national regulators. [10]

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[6] International Chamber of Commerce, *Global Risks Trade Finance Report* 2014, p. 40

[7] IBID, p. 48

[8] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (CRDIV/CRR): Article 429, Para 10 (b) and (c) and Annex 1

[9] Basel Committee on Banking Supervision: *The Management of Banks' Off-Balance Sheet Exposures*; March 1986, p. 17

[10] In this context, also providing guidance that Annex 1, section 10, clause 55 of the Consultative Document will apply when the availability of off-balance sheet exposures (e.g. import LC, export LC confirmations, acceptances and guarantees) and officially supported export credits are structured as committed facilities/limits is an important distinction to ensure the appropriate lower CCF is applied.

In addition, the Standardized Approach text references a 20% CCF being applied to LCs which are collateralized by underlying shipments. As the word "collateralized" has been subject to different interpretations and has brought the notion of 'control' and 'no control' of the underlying goods by the financial institution within the ambit of the term, further clarity on this term or the removal of it entirely would also be beneficial.[11]

2. Bank Exposures

The current Standardized Approach includes two options for applying risk weights to banks. Option 1 links a bank's risk weight to the sovereign rating of the country in which the bank is incorporated, while Option 2 applies the risk weight that corresponds to a bank's credit rating. In revising the treatment of bank exposures, the Consultative Document aims to remove both references to external credit ratings and the link to a sovereign's credit risk. The Committee seeks to develop a single approach based on two risk drivers that are relevant to banks. Those drivers relate specifically to asset quality and capital adequacy.

BAFT believes that assigning these two specific risk drivers to bank exposures may not adequately assist in identifying risk that is better captured by the more structured approach of external credit ratings. For example, the use of a net non-performing asset (NPA) ratio as a factor in determining asset quality is - in effect - the third non-performing loan measure that banks would have to manage against and report. This creates additional reporting requirements which would not add additional insight on a bank's risk profile, as impairment is a lagging indicator. Rapid lending will reduce the ratio, but expose the bank to greater risk, especially in a weak environment. Conversely, a bank that slows lending or deleverages will most likely see the ratio increase, even though it is tightening its lending criteria. As such, reliance on this indicator would lead to inappropriate risk weights and is not a forward looking predictor of risk.

We also believe the proposed risk drivers likely do not take into account jurisdictional differences in the interpretation of the stated drivers. This is particularly true in jurisdictions that have not implemented Basel III or where deviations in implementation will cause material nonconformity on comparability of the risk drivers when examining bank exposures. We believe this will create an uneven playing field that could have a substantial impact on the risk weighting of bank exposures in emerging market jurisdictions, which could in turn impact the flow of cross border commerce in the areas of the world most acutely in need of financial infrastructure support. The proposal will also particularly impact the United States, where only large banks apply Basel III. The Committee recognizes that while Basel III is primarily designed for internationally active banks, the proposed approach would mean de facto that obligor banks would have to apply Basel III, both for the calculation of capital and the calculation of risk-weighted assets, even if they are not internationally active or the national supervisor has not adopted Basel III. The Committee notes that this could be burdensome for banks not subject to the Basel III standards, and we agree that this will indeed have considerable negative effects on these particular institutions.

In addition, as various banks have large funding positions with other banks, the increase in capital requirements based on the exposure methodology outlined will lead to a significant rise in funding costs, as higher capital requirements will exponentially increase the funding prices. This potential double counting should be considered when setting any new risk weights.

BAFT believes that taking into account the global complexity in applying the proposed risk drivers across all banks subject to the Standardized Approach, the proposal would lead to negative downstream impacts on cross border finance and could, in turn, create undue disparity in the interpretation of risk weights for

[11] For background on the definition and practical application of LCs, please see: *BAFT Traditional Trade Finance Definitions*, February 2012, available at www.baft.org/policy/library-of-documents/traditional-trade-finance-definitions

bank exposures, which would appear to be the opposite of the stated goals of the Committee in revising the Standardized Approach. For these reasons, BAFT believes that external credit ratings should be maintained for determining bank exposures as a more risk appropriate and even handed method of calculation. For unrated banks, risk weighting should follow the current Basel II Option 2 approach for bank exposures and be linked to the external rating of the sovereign jurisdiction of the bank.

However, should the Committee decide to move forward with the proposal as currently designed, consideration should be given to applying a 20 percentage point reduction to the risk weights proposed for bank exposures for trade finance products, with a cap on the risk weights for these products no greater than 150%. This recommendation is consistent with the treatment accorded by the Committee for trade finance products under Leverage Ratio (CCFs for trade finance contingent liabilities) and the LCR (0-5% outflow on trade finance contingent liabilities). This will allow for capital floors to be a better comparable measure to capital calculated based on internal models which already factor for the low risk levels in trade products. This will also ensure adequate and affordable trade credit is available to support meaningful and sustained economic growth.

3. Corporate Exposures

The current Standardized Approach applies risk weights to all corporate exposures by reference to their external credit ratings only. For unrated exposures, a flat risk weight is applied. In order to reduce reliance on ratings and increase risk sensitivity vis-à-vis exposures to senior corporate debt, the Committee has focused on two risk drivers with a perceived higher level of explanatory power and simplicity - revenue and leverage. The proposal assigns risk weights from a table ranging from 60% to 300%, based on a corporate's revenue and leverage. The table is designed to reflect the expectation that (i) a corporate with higher revenues and lower leverage will have a lower risk of default and therefore should receive a lower risk weight, and (ii) a corporate with negative equity has a higher risk of default. To calculate revenue and leverage, banks are expected to use the obligor's year end accounts for the most recent financial year available. A corporate exposure would be assigned a 300% risk weight if the data needed to calculate revenue and leverage are not made available when required.

BAFT believes that the proposed risk drivers of revenue and leverage are too simplistic to be applied across the wide range of corporate entities captured by the revised Standardized Approach proposals. For certain entities, these risk drivers may not be available or may not be truly representative of a corporate's risk position. Indeed, both revenue and leverage can be substantially different indicators where different accounting treatment or different leverage calculations are applied in dissimilar jurisdictions and in divergent ways depending on the corporate sector. This is particularly true for small and medium sized enterprises (SME), where most exposures to smaller corporates are highly collateralized relative to exposures to large corporates and risk mitigating factors such as received guarantees and other collateral are not taken into account. In addition, the Committee's proposals on specialized lending in this space do not reflect the often lower risk nature of commodity finance transactions. Taken in total, the proposals will lead in many cases to the application of the maximum counterparty risk weighting envisioned, which would not be risk sensitive and would unnecessarily penalize some corporate entities.

We have particular concerns when these risk drivers are applied to emerging market corporates, where publication of financial statements is not always compulsory. By not supplying the data required to calculate revenue and leverage in this regard, these types of corporate exposures would potentially be assigned a 300% risk weight, effectively tripling the risk weights for a sector of the world economy most in need institutional financial support. This will in turn harm economic growth and impede the global development agenda espoused by the G-20.

We strongly believe the proposal in this area should be reevaluated so as not to cause undue strain on the financing of businesses around the world. The use of external credit ratings for corporate exposures should be maintained and where the Committee believes this to be unrepresentative of the actual risk posed, a more granular approach to the development of risk drivers should be considered to take into account the complexity of the corporate sector, the varying jurisdictions covered and the size of the entity in question. This could be accomplished by using benchmarking data to assess the selected set of metrics and their risk calibration.[12]

Should the Committee decide to move forward, however, with the proposal without the alterations suggested herein, consideration should be given to applying a 20 percentage point reduction to the risk weights proposed for corporate exposures for trade finance products, with a cap on the risk weights for these products no greater than 150%. As proposed under our alternative recommendations relative to bank exposures, this will allow for capital floors to be a better comparable measure to capital calculated based on internal models which already factor for the low risk levels in trade products.

4. Multilateral Development Bank Exposures

Currently, risk weights applied to claims on multilateral development banks (MDB) are generally treated as bank exposures, based on an MDB's external credit rating. In the case of highly rated MDBs which comply with strict eligibility criteria, a 0% risk weight applies. The Consultative Document proposes to maintain the 0% preferential treatment for the current list of highly rated MDBs.[13] For the remaining population of MDBs, the Committee believes that their business models, corporate governance structure and shareholder composition are very specific and ill-suited to the proposed risk-weight treatment for bank exposures. Therefore, the Committee proposes that the fallback treatment for claims on MDBs should be as corporate exposures. Recognizing that such treatment might be unduly punitive, the Committee proposes to introduce a subcategory of "qualifying MDBs" that retains the current risk weights based on the MDB's external credit rating, provided that certain conditions are met.[14]

BAFT agrees that the current list of highly rated MDBs is appropriate (though we note that the list should be regularly reviewed to ensure all eligible MDBs are captured, as circumstances for certain MDBs change over time). However, we strongly disagree with the Committee's proposal that the fallback treatment for claims on MDBs should be as corporate exposures. As with our commentary on the issues with risk drivers for corporate exposures, leverage and revenue are particularly ill-suited for determining the risk weighting of multilateral institutions, which have far different structures, ownership, management, and mandates than a corporate entity. Indeed, there is ample evidence to support the notion that MDBs display a strong resemblance to financial institutions rather than corporates. Most MDBs benefit from treaty arrangements where member countries give them preferred creditor status as a manifestation of the shareholder support. As such, even when sovereigns (being the majority borrowers) default on private creditors they continue to honour MDB obligations. MDBs also benefit from tax immunities or zero tax requirements (which allow for the accumulation and retention of profits for use in developmental activity) and the ability to act as lender on record. MDBs tend to be well capitalized with highly

[12] In addition, we understand that the Standardized Approach has not generally recognized physical collateral (with the exception of real estate) for regulatory capital purposes because it has always emphasized simplicity. The revised Standardized Approach proposals, however, aim to reflect a reasonable extent of riskiness of exposures and increase comparability of capital requirements under the Standardized Approach and the IRB approach. In this regard, we believe a revised Standardized Approach can achieve both objectives without resulting in undue complexity by recognizing credit risk mitigation to corporate exposures secured by non-financial collateral (*i.e.*, commodities, transportation, industrial, or office equipment that are secondary to the servicing of the loan and yet substantially increase prospects of recovery in case of default). These collateral types are already recognized under the IRB approach, thus putting non-IRB banks at a disadvantage in this large segment of commercial lending. We believe appropriate and simple adjustments can be made to the proposed framework to reflect the risk mitigating effect of these collateral types by adjusting downwards the corporate risk weights.

[13] Basel Committee on Banking Supervision: *Revisions to the Standardised Approach for credit risk;* December 2014, Footnote 47

[14] IBID, Annex 1, Paragraph 11(b)

conservative balance sheets compared to traditional financial institutions (FI), and their multilateral projects, balance sheet structure, and lending and loan portfolios are similar to that of banks and other large (non-retail borrowing) FI's. MDBs support bank lending and long term project finance exposures by virtue of their guarantees and ability to take long term credit risk, which is akin to FI's providing additional credit support by virtue of their guarantees. This is unlike the situation for corporate entities, where exposures are geared towards managing their own project and subsidiary risk.[15]

Taking this background into account, we agree that where a MDB meets the criteria laid out in Annex 1, Section 3, Paragraph 11(a) of the Consultative Document, it should be treated as a highly rated MDB. However, these criteria are in some cases subjective to the MDB in question. Many emerging market MDBs may not always fulfill the requirements of Paragraph 11(a) or the reduced requirements outlined to be a "Qualifying MDB" under Paragraph 11(b). With a higher cost of capital for risk participations involving MDBs possible under the proposal, the availability of trade credit for emerging economies is likely to be constrained and international trade flows will be unduly impacted. To avoid negative effects for multilateral economic support in developing economies, we encourage the Committee to maintain the use of external credit ratings as the primary driver to assess the risk weighting of all MDBs that do not meet the criteria to be considered highly rated for the purposes of the Standardized Approach.

We also believe the Committee should take the opportunity to consider the criteria of a "high rated" MDB in order to better assist in ensuring that the mandate of a wider variety of MDBs is supported by applying the appropriate risk weighting to the institutional exposure. As such, we believe the Committee should add clarity in terms of the potential range of long term issuer ratings acceptable, the level of sovereign proportion in the shareholder structure, and the level of leverage of the MDB in lieu of applying more subjective criteria. We also request the Committee review some conditions specific to Annex 1 Paragraph 11(a) subsections (ii) and (iii) based on the following points:

a) Shareholder performance irrespective of the rating of the shareholding country is also vital. Lower rated country commitments should be measured by their demonstrated ability to subscribe to capital and pay on time versus purely applying the country rating;

b) Due consideration should be made on the extent of callable capital commitment from non-investment grade countries and their ability to pay such amounts in time of need. For instance, if a country has been subscribing to required amounts of capital and paying on time, then consideration should be given to how much callable capital that country has pledged and its potential ability to pay such amounts in times of need;

c) Most MDBs limit the amount of their direct obligations by using structures such as funds or sub-entities to extend guarantees, aid or grants for less developed countries where credit support is more risky in order to limit the amount of the direct obligations on the principal entity for management of credit risk. For example the African Development Bank (AfDB) classifies countries as middle and lower income, and - for lower income countries - support is extended via the African Development Fund instead of the AfDB;

[15] Furthermore, it is important to note that the methodology for determining ratings used by rating agencies treats MDBs as a combination of a bank and a sovereign. S&P and Moody's assign a stand-alone (financial strength) rating based on adjusted bank financial ratings drivers falling broadly into two categories: capital adequacy (about 60%) and liquidity (about 40%), while S&P also adds the policy mandate and management quality. Government support is then added to the stand-alone rating and this is driven by the policy importance of the organization, along with preferred creditor status. Moody's methodology also notes that the rating stability for the MDB sector has been much higher than the global corporate sector, despite the fact that the size of the MDB sector is extremely small compared to the size of the global corporate sector.

d) Given that operations of MDBs are primarily financial in nature, exposures are diversified to a large number of institutions, sovereigns and customers. This is unlike corporates, where exposures are concentrated to subsidiaries, own operations and distributors/large customers utilizing the product. As such, the quantum of funds required is much higher, and leverage is essential given the nature of the support extended but well mitigated through much wider portfolio diversification.

5. Export Credit Agency Exposures

BAFT believes the Basel Committee should take the opportunity in reconsidering the Standardized Approach to provide great clarity on the treatment of credit risk mitigation from Export Credit Agency (ECA) and private credit insurance products. Though we understand that claims on sovereigns and their central banks is out of scope for this proposal and that the Committee is separately considering the treatment of sovereigns, the scope of credit risk mitigation techniques and the style of the contract acting as a credit risk mitigant should be clarified through the current consultative review. In particular, for credit risk mitigation techniques that meet the criteria of a guarantee, it should be not be an issue of whether the credit risk mitigant is "styled" as a guarantee or an insurance product. If the underlying contract fulfills the minimum operational conditions set out by the Committee, banks should be able to take account of the credit protection offered by such credit risk mitigation techniques in calculating capital requirements. As such, insurance contracts (whether they are an ECA product or private credit insurance) which meet the minimum operational and legal conditions set out under Sections 125-128 of Annex 1 of the Consultative Document should be recognised as eligible collateral in the calculation of capital requirements. We note this concept was acknowledged by the Basel Committee under the QIS Frequently Asked Questions publication dated December 20, 2002.[16] Though we understand this clarification was very limited in scope, updated guidance on this matter would be beneficial.

Lastly, we consider it important to highlight that ECAs also offer unfunded credit protection in the form of guarantees and insurance contracts which are often unrated, especially when they are established in emerging markets. As such, BAFT recommends that external ratings be used for the part of the loan covered by ECA credit insurance or guarantees. The risk weighting of ECA credit insurance and guarantees should be categorized according to the sovereign rating of the respective country supervising the ECA. For the portion of the loan not covered by an ECA, banks should be allowed to use the risk scores published by individual ECAs that are recognized by their national supervisors or the consensus risk scores of ECAs participating in the Organization for Economic Cooperation and Development (OECD) "Arrangement on Officially Supported Export Credits", as currently recognized within the existing Basel framework and suggested under Annex 1 Section 1 of the Consultative Document relating to exposures to sovereigns.

Conclusion and Capital Floors Interaction:

BAFT believes that the appropriate regulatory treatment for transaction banking services will ultimately have a positive effect on global markets and will spur job creation and growth in the real economy. As such, we believe our comments, taken in conjunction with our recommendation on a more considered and longer term view of revisions to the Standardized Approach, will beneficially impact that goal. In addition, as the Committee moves forward with their review of their Capital Floors Proposal, it is vital the Committee also consider the interaction between the Standardized Approach revisions and the possible implementation of capital floors. The introduction of capital floors for banks on the IRB approach will not improve the comparability of Risk Weighted Assets (RWA), but instead flatten capital requirements in low risk businesses. In particular, they will diminish the value of collateral and other securities and increase systemic risk as capital outcomes will converge, resulting in more expensive financing and reduced

[16] Basel Committee on Banking Supervision, *QIS Frequently Asked Questions* (as of 20 December 2002); p. 11, Question 6

product availability. This will limit liquidity in the system and will perversely incentivize banks to engage in higher risk businesses in order to compensate for the higher capital charge required to meet the return on equity targets. Ultimately, this will negatively impact the availability and affordability of crucial transaction banking products like trade finance, which could result in reduced global trade flows at a time when they are essential to support economic growth. The Committee should focus instead on targeted and considered revisions to Standardized and IRB approaches to ensure enhanced granularity and risk sensitivity along with more comparability in the dual approaches to credit risk.

We very much appreciate the opportunity to comment on the Committee's proposals and we look forward to further dialogue on these important issues going forward. For further information, please contact Matthew L. Ekberg, Vice President, International Policy at mekberg@baft.org or +1-202-663-5537.

Very truly yours,

Tod R. Burwell

Tod R. Burwell
President and Chief Executive Officer