

BBA response to the Basel Committee on Banking Supervision's consultation on
Revisions to the Standardised Approach for credit risk

March 2015

The BBA is pleased to respond to the Basel Committee on Banking Supervision's (BCBS) consultation on Revisions to the Standardised Approach for credit risk¹.

The BBA is the leading trade association for the UK banking sector with more than 200 member banks headquartered in over 50 countries with operations in 180 jurisdictions worldwide. Eighty per cent of global systemically important banks are members of the BBA. As the representative of the world's largest international banking cluster the BBA is the voice of UK banking, enabling us to represent our members domestically, in Europe and on the global stage. Our network also includes over 80 of the world's leading financial and professional services organisations. Our members manage more than £7 trillion in UK banking assets, employ nearly half a million individuals nationally, contribute over £60 billion to the UK economy each year and lend over £150 billion to UK businesses. They use both standardised and internal ratings based approaches to calculate the regulatory capital they should hold against their risk weighted assets. So if implemented the proposals are likely to have a significant impact on all our members.

Before responding to the BCBS's specific questions we highlight below some more general comments.

Key messages

The industry supports a more risk sensitive approach

Our members support a more risk sensitive and granular approach to calculating credit risk, be it under the standardised or internal ratings based approaches, in order that the capital banks hold against their exposures better reflects the risk of loss. We do not believe the current proposals achieve this for all asset classes and look forward to discussing with the Committee their attribution models that have identified the factors chosen and working with the Basel Committee so that a more risk sensitive approach can be created which is relevant to each asset class.

Is this a solution without a problem?

We agree that scrutiny is required to identify the fragilities of the current standardised approach. But the consultation paper proposes revised solutions for asset classes with which it is not currently obvious to us that problems exist. In proposing alternatives the task force should focus on asset classes which cause it real concern, in a staged manner, concentrating on the most problematic areas first.

¹ <http://www.bis.org/bcbs/publ/d307.pdf>

The identification of the asset classes on which to focus could be aided by the scrutiny of the results of the stress testing exercises that have been widely undertaken in recent years. We believe these will contain a rich source of information that should be mined to identify a prioritised list of asset classes. Our members would be pleased to work with the task force to assist in the prioritisation.

The impact of the proposed changes will be wide ranging

If implemented, the proposed changes will have a profound effect on the way that banks perform the fundamental role they undertake for society, that of taking deposits, lending money, facilitating money transmission and providing risk management services. The changes if introduced as proposed would cause some banks, particularly those that may be smaller and focussed on providing finance to niche markets, to reconsider their business models, including the price at which they lend to different types of counterparty. It is quite conceivable that some categories of business would become uneconomic for banks and in our view barriers to entry will be raised for new entrant challenger banks which are an increasingly important competent of the UK banking market .

This runs the risk of starving some parts of an institution's business that, while costly to run and consumptive of capital, are of high social value. Unsatisfied lending demand could be met by the shadow banking sector with the implication that counterparty exposures will be less visible to the regulatory community.

At the same time we are concerned that a combination of pressure from regulators and investors will force institutions into copycat strategies with the attendant possibility of herding behaviour that will concentrate risk, particularly if the standardised RWA calculation becomes the binding constraint because of the application of capital floors to institutions using IRB approaches.

SMEs will be particularly impacted

An effect of the risk factors proposed for SME lending, which often are not reported on by smaller businesses, will be the application of a 300% risk weighting with consequent impacts on supply and pricing of small business finance. We propose instead a combination of behavioural and financial metrics which more properly reflects the way in which our members currently assess their SME customer base. This would avoid these very potentially very damaging impacts.

Intuitively capital requirements will rise

Although it is a stated objective of the Committee that regulatory capital across the banking industry should not increase, intuitively we believe that it will across many of the asset classes. As well as the SME portfolio mentioned above, the treatment of short term interbank claims, the removal of some existing approaches and the treatment of conversion factors will also result in significantly increased capital requirements.

Any changes should not be rushed

Although the timeframe for actually introducing changes to the standardised approach to credit risk is unclear, we do not think it will be feasible to consult on the proposals, undertake and analyse the results of a quantitative impact study, consult once again with the industry if the Committee decides to amend its approach and finalise the approach by the end of 2015.

The Basel Committee should recognise now that this would be a very significant task for banks and be willing to contemplate a more measured timetable that will permit a well-considered approach to be developed including recognition that at least one follow up QIS will be required in order to properly understand the impact of any new standardised approach. A wealth of information is also available to regulators via their understanding of individual banks IRB models which should also be used to ensure the eventual calibration of the standardised approach is correct.

Will the proposed changes achieve their objectives?

The proposed changes purport to reduce the reliance on external ratings, increase risk sensitivity, strengthen the link between standardised and IRB approaches and enhance the comparability of risk weighted assets. The BBA believes it is arguable that none of these objectives (other than the first!) will be achieved if the new proposals were to be introduced as drafted. The revised standardised framework must continue to signal to institutions that greater risk sensitivity, including an expectation that the foundation and advanced Internal Ratings Based approaches (IRB) when properly applied can support this, remains a cross-cutting objective of the Basel Committee. It is important to recognise that the aIRB approach had not been implemented at the start of the financial crisis.

External ratings remain relevant

We do not dispute that external ratings were poor indicators of the probability of default for certain asset classes, particularly sub-prime US mortgages and CLOs and CDOs, which were nonetheless pivotal in determining the severity of the global financial crisis. Likewise there should not be a mechanistic reliance on ratings. But we do not agree that credit ratings failed in general. For more conventional banking exposures, such as corporate loans they remain good, forward looking indicators of credit quality and predictors of default so we believe that where external ratings work well for particular asset classes they should be retained as the default option under the standardised approach.

The Committee has already recently re-affirmed that external ratings are relevant in defining securitisation RWAs so we do not perceive a real conflict in their continuing use in the revised standardised approach.

Rating agencies' analysis takes account of geographical and industry specificities, liquidity and funding, both strong measures of vulnerability and is based on a granular analysis of the risks the rated entity faces. Permitting banks on the standardised approach to continue to calculate their RWAs using entity specific external ratings (where this is not prohibited by national law) will avoid both a one size fits all approach and ensure that the costs of migrating to a revised standardised approach are proportionate to the risks being measured.

The data may not be available

A range of different data points will be required to implement the proposed approach successfully. We believe that, to ensure consistency, information should be drawn from a bank's Pillar 3 reports the content of which has just been revised. However the Pillar 3 templates would need further revision to accommodate the proposed look-up table approach. We do not believe this can be completed within the end 2016 timeframe contemplated for the introduction of the new Pillar 3 reporting. Banks are naturally reluctant to make Pillar 3 changes in the knowledge that disclosure

standards will have to be changed again depending on the outcome of the Committee's deliberations on a revised standardised approach for credit risk.

For retail type exposures metrics such as the borrower's debt service coverage ratio may not be readily available at all in some jurisdictions and, where they are available, will undoubtedly be subject to national variations caused by different interpretation of available income, as the CP correctly notes. It is not clear to us that this problem can be solved. Similarly records may simply not have been kept on the value of a property at the point of origination of a mortgage loan that was made many years ago.

In many jurisdictions smaller companies can opt out of the requirement to publically file any accounts at all. Where they do file accounts, this may be up to nine months after the financial year end. Furthermore, accounts are usually based on a historic cost approach to the valuation of assets which is likely to distort the leverage measure. We do not believe it is right to require small business to change their accounting conventions in order that banks can observe this required risk driver on a current value basis.

Many of the proposed risk drivers are based on accounting conventions that are not yet globally harmonised - it is difficult to see how the use of metrics based on numbers in financial statements that may differ from country to country will contribute to a standardised approach to credit risk calculation.

Significant IT builds may be required in order to implement the proposed requirements which the Committee should take into consideration in relation to the implementation timeframe.

Risk profiles differ

The Basel Committee's premise on which it builds the revised approach appears to be that risk drivers and loss experiences are the same in all countries and thus a homogenous, conservative standardised model should be used by all institutions. In doing so it seeks to impose a global one-size-fits all approach. We do not believe that standardised models that ignore size, legal structure, concentration and/or diversity of banks and the differing nature of their customer bases in different economies do actually deliver a more risk sensitive and granular approach to calculating credit risk.

So we are not convinced that a simple up to two factor model by asset class, even were it to be subject to fully transparent national calibration would be sufficient to deliver locally relevant risk sensitivity. In some cases local definition of factors will be necessary. Such local definition or calibration could be either up or down from the global model. In proposing this, we do not seek to re-introduce national discretions that can favour 'national champions' but rather to recognise that jurisdictional and local market differences will always exist and should be accommodated.

The need to take local factors into account is already well recognised by regulators, for instance in IRB approaches which are calibrated to local data, and in the application of countercyclical and other macro prudential buffers.

The proposals ignore the benefit of security

In many cases lending to small and large corporates is secured by physical security, either by a floating charge or over the asset that is being financed, which may be a van, a photocopier or

commercial property. This acts as a credit risk mitigant of real value. By focusing on probability of default and only recognising the benefit of financial collateral, as we believe the Committee's new proposals do, the loss given default benefits that other forms of security can bring are not considered.

Answers to questions

Exposures to banks

- Q1** What are respondents' views on the selection of the capital adequacy ratio? In particular, is the CET1 ratio superior to the Tier 1 ratio or the Leverage ratio? Do respondents agree that it is necessary to require calculations in accordance with Basel III in order to ensure a consistent implementation?

We are agnostic about the choice of total Tier 1 or Common Equity Tier 1 (CET1) as the risk driver but note that CET1 has become the most widely used yardstick by investors, supervisors and banks themselves. Whichever measure is chosen it will be important, in order that comparability is promoted, to calculate the capital ratio in accordance with Basel III, as all BBA member banks currently do if they are supervised as a banking entity in the UK. This may not be the case however in other countries.

We see the back-stop leverage ratio as a quasi-standardised approach that is even less risk sensitive than the proposed revised standardised approach so would not support its use instead of a CET1 ratio – it would be less likely to achieve the Committee's goals.

External rating agencies examine in a detailed transparent way a range of metrics in assigning a rating, including quantitative ones such as capital, liquidity, asset composition, funding and leverage which are supported by more qualitative overlays including the strength of the bank's management team. Removing the ability to use external credit ratings for determining the risk weights for an institution's exposure to banks is not sensible. Where credit ratings exist their use should continue to be permitted.

Replacing the current proposals with a cut-down two factor model appears to be a backward step as we are unconvinced that the predictive power of the CET1 ratio and net non-performing assets (NPAs) alone is superior to the credit rating based on a multi-factor analysis. But we look forward to discussing with the Committee its attribution model that demonstrates that this is the case.

We acknowledge that the CET1 ratio is a key metric so should be one of the two factors in assessing the credit risk of an exposure to a bank but note that it is a backward looking metric and, like a number of the risk factors proposed, could introduce a degree of procyclicality into the calculation of bank exposures under the standardised approach, negating the objective of the counter-cyclical capital buffer.

There is also a degree of circularity in the use by one bank of the CET1 ratio that has been calculated by another. Where banks only report on an annual basis there is the possibility of unhelpfully volatile changes in capital requirements when results are published.

It will be important that all banks use the 'same' number, which we recommend should be based on the calculation methodology used for the Pillar 3 disclosures in force at the time it is determined and applied to the immediately preceding year end figure, which should be submitted to a central register which could then be accessed by all banks.

- Q2. Do respondents believe the net NPA ratio is an effective measure for distinguishing a bank exposure's credit risk? What alternative asset quality measure, if any, should be considered by the Committee?

We foresee problems with utilising the NPA as the second metric in the simplified two factor model proposed in the revised standardised approach. For instance:

- NPA measures will tend to be procyclical, increasing during periods of economic stress which could force banks to rein in their new lending, exacerbating the economic downturn further;
- NPA calculation mechanisms will differ, depending on the internal policies and jurisdictional specificities that determine the timing of when an asset is recognised as being non-performing, whether the bank decides to retain that asset or sell it down or when it is written off;
- The NPA proposal does not take into account tangible security held against NPA's nor its impairment. If this measure is going to be used the figure should be net of both;
- NPA and CET1 factors are likely to be correlated making them unsatisfactory bed-fellows in the simple model which is being proposed;
- NPA levels will be dependent on the accounting approach adopted, which differs between jurisdictions and will be significantly revised with the introduction of IFRS 9, which will introduce a time-series discontinuity as it supersedes the current IAS 39 regime.

- Q3. Do respondents have views on the proposed treatment for short-term interbank claims?

We support the application of a differential treatment to short term claims in order to promote interbank market liquidity.

We are concerned by the requirement that short term interbank claims that are expected to be rolled over should be excluded from the preferential treatment. It will be difficult for the bank and its supervisor to objectively test whether this is the case or not so we suggest removing this requirement and basing preferential treatment solely on the original maturity.

The three month cut-off risks introducing a cliff effect into the calculation methodology. We believe there could be merit in introducing a graduated approach, depending on the original maturity of the interbank claim for the period between three months and one year. Whilst acknowledging that this would introduce some additional complexity, this would further and beneficially enhance market liquidity of slightly longer maturity deposits whilst introducing little extra risk.

- Q4. Do respondents have suggestions on how to address these concerns on the treatment of exposures to banks? In particular, do respondents have views on how to treat exposures to banks not subject to Basel III in a consistent and risk-sensitive manner?

It will be important to treat exposures to banks in a consistent manner, whether or not they are subject to Basel III and we expect the market to adjust to this. If it does not larger banks will not place deposits with smaller banks unless they comply with the necessary disclosure requirements to enable them to make the required assessment, meaning that Basel III will soon become the predominant approach.

Exposures to corporates

- Q5. Do respondents have views on the selection of risk drivers and their definition, in particular as regards leverage and the incorporation of off-balance sheet exposures within the ratio? Would other risk drivers better reflect the credit risk of corporate exposures?

The proposed drivers are not suitable metrics for calculating risk weighted assets for corporate exposures. External ratings of corporates have performed well as indicators of failure, based on long time-series of data and their efficacy was not called into question during the global financial crisis.

Where external ratings exist their continued use should be permitted as they contain much more information and are more forward looking than revenue and leverage alone.

Where ratings do not exist – realistically this will apply to the great majority of our members' corporate exposures - focussing on revenue, rather than profitability from which flows the ability to continue servicing debt obligations, does not in our view provide an adequate perspective on risk. Furthermore it disadvantages smaller businesses and ignores the value of any collateral, physical or financial that has been pledged in support of the obligation.

Leverage is not a better indicator of the likelihood of payment as it suffers from a number of drawbacks including a lack of recognition, for instance, that a more highly geared corporate exposure in one industry segment might be less likely to default on its obligations than a less geared corporate in another industry sector. These differences might occur because of different accounting approaches, a greater cultural tolerance for higher levels of leverage or different business models or regulatory environments. For instance the rate-of-return regulation of utility businesses in some parts of the world, the price regulation of pharmaceutical manufactures or the typically much greater leverage of insurance companies all suggest a more tailored approach is required.

As a complement, or alternative, to the leverage ratio a gearing ratio, being the ratio of debt to equity and an interest coverage ratio could be considered. These metrics have been used as the basis of covenants in loan documentation for many years and have proved their worth, although where available we believe external credit ratings should be the primary risk driver.

- Q6. Do respondents have views on the appropriateness of the proposed treatment, especially with regard to SMEs? And about the more lenient treatment for start-up companies?

The proposed fall back to a 300% risk weighting for a business, perhaps an SME, that has not provided leverage and revenue data to the bank or is in negative equity is unduly penal. It runs the risk of starving the SME lending part of banks' businesses that, while costly to run and consumptive of capital, are of high social value. In the UK business lending may make up only 18 per cent of bank loan books, or closer to 10 per cent if property lending is removed, but it is disproportionately important to the economy as a whole. As in many other countries too, the majority of businesses are SMEs and employ the majority of private sector workers. The penal increase proposed will have profound effects on SMEs which runs completely counter to the policy of many governments and the G-20 as they seek to encourage small businesses to grow. We should also note that SME lending did not cause the last crisis nor did it particularly prolong it.

In a number of jurisdictions there is no requirement for a company to file accounts publically and requiring SMEs to suffer the expenses of preparing year end accounts would be unnecessary when banks have other mechanisms to monitor their ability to pay. For instance where a bank also provides the business with current account services it has a wealth of transactional data allowing it to assess the changing financial health of its borrower and the combination of credit reference agency, behavioural and transactional information (uninfluenced for instance by the SME's sales revenues) is currently the basis of banks' lending decisions, and should remain so.

Similarly an exposure to an SME, the accounts of which show it to be in negative equity, might not represent a significant risk to the lender which has security over for instance property, plant or equipment that is reflected in the accounts on a depreciated, historic cost basis where such collateral has a higher current market value.

Whilst we note that start-up SMEs may be afforded a lower risk weighting. It is not our experience that such a perspective is borne out in practice. The risk of firm failure is highest in its first few years of operation.

Another area where further clarification could aid risk sensitivity would be in the treatment of secured letters of credit. These are commonly provided to insurers and involve a segregated collateral account at a custodian invested in liquid financial securities. These facilities are usually required by clients on a committed basis although utilisation is contingent on an insured event. Any drawings under the facility agreement are subject to strict legal requirements around collateral cover and would benefit from credit risk mitigation. However, unutilised portions of these facilities are currently effectively treated as unsecured from an RWA perspective (as clients understandably resist collateralising obligations that do not yet exist), which is a poor reflection of the actual credit risk. The proposed SA-CR rules are potentially open to interpretation on this point so clarification and/or a more risk sensitive alternative would be welcome.

- Q7. Do respondents think that the risk sensitivity of the proposal can be further increased without introducing excessive complexity?

We support the BCBS initiative to establish a more risk sensitive standardised framework and its attempt to do so without introducing undue operational complexity that is at the same time sufficiently transparent. For this reason, we support the introduction of a (maximum) two factor model which, whilst not perfect, will directionally estimate the underlying risk. We believe this can best be achieved through leveraging the experience of IRB firms, to understand the principal drivers by asset class and/or geography. Such data should exist, and its use would create a natural stepping stone for firms aspiring to IRB.

Specialised lending

- Q8. Do respondents agree that introducing the specialised lending category enhances the risk sensitivity of the standardised approach and its alignment with IRB?

Specialised lending is an important category for a number of our members who are only able to provide support for infrastructure development via well-secured project finance because of the weak covenant of the underlying project sponsor.

We note that the proposed standardised risk weights for specialised lending are significantly higher than the corresponding IRB approach which, depending on the level of the floor, may make the standardised approach the constraining factor for all specialised lending.

We believe there is merit in considering the use of an adapted slotting approach to make the standardised approach more risk sensitive.

SPV's are an important financing mechanism for property developers of income producing real estate and property investment companies. Whilst agreeing that lending to SPV's can be more risky due to the reliance on the underlying security to repay lending, the arbitrary 120% risk weighting is not only high but is not adequately risk sensitive. For example loans to property SPV's at either 50% or 100% LTVs would attract the same risk weighting of 120%.

It is often common for property SPVs to have negative reserves if a property has not been revalued for accounting purposes but this would have no bearing on the ability of the customer to repay the lending through the realisation of security. It is important to differentiate between accounting values and market values which can often be quite different.

Retail portfolio

- Q9. Can respondents suggest, and provide evidence on, how to increase the risk sensitivity of the regulatory retail exposures treatment, either by differentiating certain product subcategories for which a specific risk weight may be appropriate; or by suggesting simple risk drivers that could be used to assess the risk of all retail exposures?

The 0.2% granularity criterion may adversely impact some of our smaller member banks with more tailored or specialised lending activities.

In order to make the framework more risk sensitive, we suggest that the following secondary factors could be considered: delinquency and days past due, ageing of the exposure, utilisation, term, product type, as well as LTV. Empirical evidence confirms that all these drivers provide a meaningful differentiation of risk. They should be available for most jurisdictions and at most financial institutions.

Exposures to small businesses backed by a personal guarantee should qualify as part of the regulatory retail portfolio. Moreover, the size factor for small and medium enterprises (SMEs) should be set at an appropriate level so as not to disadvantage this important part of the economy.

Whilst supportive of the 75% risk weight as a starting point for regulatory retail exposures, we consider that there could be a distinction between Qualifying Revolving Retail Exposures (QRRE) such as credit cards and personal current accounts, which exhibit a low volatility of expected loss rates, and other regulatory retail exposures.

This would strengthen the link with the IRB approach where a factor is applied to reduce QRRE risk weights. We note that it is not unusual for the risk weights for QRRE to be higher under IRB than they are under the Standardised Approach.

Claims secured by real estate

Q10. Do respondents agree that LTV and/or DSC ratios (as defined in Annex 1 paragraphs 40 and 41) have sufficient predictive power of loan default and/or loss incurred for exposures secured on residential real estate?

We support the introduction of a more risk sensitive approach for residential real estate. We agree that LTV is an important indicator of losses, but consider that DSC would be inappropriate as there are many conceptual and operational challenges which would limit the effectiveness of its use. We have considered other alternative measures including age of the facility and propose that days past due is used to supplement LTV. This is something that all firms will be able to implement and provides a real differentiation in the likelihood to default. For LTV we strongly recommend that consideration is given to distinguishing between owner occupier and other forms of residential real estate.

For example, in the UK, the proposed changes have potentially significant ramifications and are almost in the opposite direction of UK government policy enacted through stimulating the housing market through “Help to Buy” focussed at helping excluded borrowers enter the property market through higher LTV lending. There is now further support announced in the UK 2015 budget statement through the so-called Help to Buy ISA initiative.

If standardised risk weights were applied on the UK mortgage market, either directly or through an un-adjusted risk weight floor, it will potentially have a significant impact on mortgage prices for otherwise “low risk” sub-80% LTVs. Lending rates will need to be reconsidered to reflect the increased capital requirement which could add to the cost of providing a mortgage to the consumer. This potentially has the consequence of adversely impacting on house prices, equivalent to a significant rise in funding rate and could bring about a stress test type economic shock.

We note however that local calibration of two factors within a globally consistent definition, which we support, will not be sufficient to deliver locally relevant risk sensitivity. In some cases a local definition of the factor(s) (or even selection of the factors) will be necessary. The primary challenge will not be calibration of LTV that drives different risk weights, but instead the definition of some sort of a-cyclical value. It is likely that such a definition will vary by country, given different degrees of cyclicity in domestic housing markets across geographies.

As well as being of doubtful efficacy, the use of DSC will introduce spurious accuracy into the calculation of the RWAs for exposures secured by residential real estate as this category is particularly affected by different local and jurisdictional practices and norms in bank practice. These may include different personal tax regimes, insolvency legislation, lack of availability of data or its inconsistency across jurisdictions.

Where additional collateral or other support, perhaps a parental guarantee or mortgage insurance is available this should also be recognised.

In many countries rental homes are both an accessible form of investment for households (the traditional UK buy-to-let sector), and a meaningful element of the professional/institutional CRE market (termed multifamily or private rented sector). It can be

carried out on a very small scale by individuals or on a large scale by institutions, specialised residential REITs, etc.

We interpret the proposals on claims secured by real estate as including buy-to-let assets, which we believe is appropriate. Buy-to-let properties are collateralised in the same way as mainstream residential mortgages and the risk profile is similar whether the borrower is the occupier or a landlord. In general a well-managed buy-to-let portfolio has a comparable risk profile to owner-occupied residential real estate, as the landlord will typically have a diversified income stream to cover for individual tenant specific problems. Buy-to-let should not be treated in the same way as offices, retail, and industrial property.

The treatment of such exposures was considered during the development of the EU Capital Requirements Regulations (CRR). It was concluded that in territories where a well-developed and long-established residential real estate market exists, with loss rates which are sufficiently low to justify such treatment, such exposures should be treated as secured on residential real estate. The consultation does not present any new evidence to support a change to this approach

Attaching quite different risk weights to “residential” and “commercial” property lending creates a significant potential cliff-edge around the treatment of non-owner-occupied home loans. It would be helpful to have more clarity about how the line would be drawn between “residential real estate” and “commercial real estate” for lenders.

- Q11. Do respondents have views about the measurement of the LTV and DSC ratios? (In particular, as regards keeping the value of the property constant as measured at origination in the calculation of the LTV ratio; and not updating the DSC ratio over time.)

There are practical benefits to using origination values for LTV and DSC but doing so does not reflect the riskiness of the mortgage loan over time. Property values can go down as well as up and debt servicing capability will change as the borrower is affected by life events such as the arrival of children, the cost of their education, moving from self-employment to employment and perhaps redundancy. However it would not be easy to capture these life event impacts without a significant transition period to enable this to happen.

We doubt that using the origination LTV over the life of the mortgage would be helpfully predictive, other than perhaps in the early years of the loan. A marked to market LTV would be preferable although has its own drawbacks as the peak of the property cycle is reached.

In addition the omission of an updated property value in the LTV measurement could encourage refinancing in the marketplace, resulting in increased churn to enable lower capital requirements, for a loan with effectively the same risk. The Committee should consider carefully the impact of this potential outcome.

We believe DSC only has value as a decision factor at the point of origination of the loan. As we note above it is likely to change significantly over the lifetime of the loan as customers' socio-economic circumstances change. Furthermore, the definition of DSC would appear to result in lower capital requirements for loans with potentially higher risk (e.g. Interest Only mortgages which would exclude the principal from the debt service amount). This is evidently contrary to the Committee's intended objective of a more risk sensitive approach.

- Q12. Do respondents have views on whether the use of a fixed threshold for the DSC ratio is an appropriate way for differentiating risks and ensuring comparability across jurisdictions? If not, what reasonably simple alternatives or modifications would respondents propose while maintaining consistent outcomes?

We do not think a fixed DSC threshold is appropriate. It will not aid comparability across jurisdictions because of differences in tax regimes, data availability and social security safety nets, for which it would be difficult to adjust for in a consistent way.

- Q13. Do respondents propose any alternative/additional risk drivers for the Committee's consideration in order to improve the risk sensitivity in this approach without unduly increasing complexity?

Other factors including delinquency, maturity, the fixed or floating nature of the mortgage obligation, the time on the bank's book and its payment structure could be considered as an indicator of default probability.

Exposures secured by commercial real estate

- Q14. Which of the two options above is viewed as the most suitable for determining the risk-weight treatment for exposures secured on commercial real estate?

We agree that commercial property, which in the UK accounts for between 8% and 12% of a typical bank's lending portfolio, has been a leading source of risk for banks over the years. This is a result of its inherently cyclical nature – long lead times in bringing new supply on line as demand picks up can lead to volatile point-in-time loan to value ratios, particularly at the turning points of the cycle. It should be noted however that a number of countries now have macro prudential policy tools designed to dampen down this property cycle.

Of the two options that are proposed we prefer option B which accords some value to the nature of the underlying real estate being financed, although not enough in our views as the range of risks weights are quite similar under either option. We note that the lowest risk weight for exposures treated as corporate exposures (60%) under option A is lower than the lowest risk weight (75%) for exposures treated as secured by commercial real estate so suggest that more granularity be added to option B at the lower LTV end which would encourage very safe property lending. This would be particularly beneficial as commercial property cycles bottom-out as it would encourage liquidity and new lending.

Commercial property is often used as security by SME borrowers and we think this category of lending deserves special attention. Under the retail treatment, unsecured SME lending would receive a 75% risk weight, while under option B, lending secured on property could be weighted significantly higher.

It seems perverse that the existence of security supporting a loan should create a higher capital requirement. Perhaps in the case of SME lending option A or B could be selected by the lending bank on an exposure by exposure basis in order that risk weights are floored at the unsecured level.

- Q15. What other options might prudently increase the risk sensitivity of the commercial real estate treatment without unduly increasing complexity?

Experience has shown that the relative safety of commercial property is dependent on the vintage of the year in which a loan is made, which equates to the point in the property cycle

in which it is extended. Thus high LTV loans in good vintage years loose less than lower LTV loans made in poor vintage years.

So a more risk sensitive approach would be to base LTV on a through the cycle (TTC) estimation. There is already a wealth of information on commercial property prices that could be back-tested and used to create a TTC adjusted 'global' index for commercial property, which in our view would be also have to be adjusted to reflect local specificities.

This could be overlaid on the current slotting approach for income producing real estate based specialised lending that would also lead to beneficially greater alignment of the standardised and IRB approaches.

Currency mismatch risk weight add-on

Q16. Do respondents agree that a risk weight add-on should be applied to only retail exposures and exposures secured by residential real estate? What are other options for addressing this risk in a simple manner?

Yes. Throughout recent history there has been significant social and banking market disruption caused by residential real estate financing strategies based on borrowing in non-domestic low interest rate currencies which have not been fully thought through and ignore the likelihood of that currency's appreciation. This can result in politically motivated fixes that retrospectively re-allocate the FX risk when it crystallises from apparently uninformed borrowers to banks at possibly significant capital cost to the industry.

A risk weight add-on for retail exposures and exposures secured by real estate will militate against this risk and bring home to individuals considering borrowing in a currency that is different from that of the principal source of income enabling them to service that loan, of the risks they are taking.

However, we acknowledge that introducing the risk weight add-on for currency mismatch at the individual exposure level may lead to complexity in the framework and applying a flat risk weight add-on may not be appropriate in some situations. For example, this would impact on lending to high net worth individuals with income from multiple currencies, which may not be the intention of the regulation.

Off balance sheet exposures

Q17. Do respondents consider the categories for which a CCF is applied under the standardised approach to be adequately defined?

We welcome the Committee's intention to use QIS data to examine the proposed re-calibration of CCFs, to align them more closely with the f-IRB approach. This impact analysis should also recognise that the proposed re-calibration will also have cross-over impacts on the large exposure and leverage ratio calculations.

As we note in our response to question 6 we believe more clarity about the application of the standardised approach to secured letters of credit would be helpful.

Q18. Do respondents agree that instruments allocated to each of the CCF categories share a similar probability of being drawn and that the probabilities implied by the CCFs are accurate? Please provide empirical support for your response.

Applying a 10% conversion factor to facilities that are unconditionally cancellable will impact the provision of working capital facilities to corporate customers, particularly to SMEs. Banks may start charging commitment fees against such unconditionally cancellable lines as a result of the proposed changes, increasing the financing costs for this important segment of the economy.

The Committee should review the type of commitments may be included in the unconditionally cancellable commitment category, which should include credit card lines or internal overdraft limits, where banks should continue to be permitted to apply a 0% conversion factor.

The Committee should also re-consider differentiating between commitments of more, or less than one year. A lack of differentiation may wrongly incentivise banks to make commitments for longer periods.

Past due loans

Q19. What are respondents' views on the alternative treatments currently envisaged for past-due loans?

We agree with the Committee that that risk weights should reflect the level of provisions. An add-on based on the amount of the provision would appear to be more risk sensitive.

Exposures to multilateral development banks

Q20. Do respondents agree with the proposed treatment for MDBs?

We believe that multilateral development banks (MDBs) display a strong resemblance to institutions rather than corporates for the following reasons:

- most MDBs benefit from treaty arrangements where member countries give them preferred creditor status (a manifestation of the shareholder support which means that even when sovereigns (the majority borrowers) default on private creditors they continue to honour MDB obligations;
- Tax immunities/zero tax requirements (which allows accumulation and retention of profits for use of developmental activity, and;
- the ability to act as lender on record.

MDBs tend to be well capitalised with highly conservative balance sheets compared to traditional financial institutions (FIs) and this is quite clear from a S&P 2012 report on supranationals which shows that the risk adjusted capital ratio is in the range of 25-30% compared to an average of 7% for 100 of the largest banks in the world. The average capital levels for banks have since increased due to increasing regulatory capital requirements.

Multilateral projects, lending and loan portfolios are similar to that of FIs and the balance sheet structure and behaviour is similar to that of banks and other large (non-retail borrowing) FIs. MDBs support bank lending and long term project finance exposures by virtue of their guarantees and ability to take long term credit risk – akin to FIs providing additional credit support by virtue of their guarantees. This is unlike corporates where exposures are more towards managing their own project risk / subsidiary risk.

Further, it is worthwhile noting that the methodology for determining ratings used by rating agencies (Moody's and S&P) treats MDBs as a combination of banks and sovereigns. Both

agencies 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 policy mandate and management quality. Government support is then overlaid on the stand-alone rating and this is driven by the policy importance of the organisation, preferred creditor status, etc. 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. So in summary, rating agencies treat the sector more akin to FIs rather than corporates.

Other assets

- Q21. What exposures would be classified under "Other assets"? Is a 100% risk weight appropriate? (Please provide evidence where possible).

Lower risk weights should be applied to some asset types, including accrued interest or cheques in the process of being collected. We also note that where cash is explicitly held as financial collateral it is accorded a 0% risk weighting and suggest that cash in hand and other cash equivalent assets is similarly weighted, an approach that could be extended to gold bullion held by banks in their own vaults.

Eligible financial collateral

- Q22. What are respondents' views on the above alternative ways to define eligible financial collateral?

We agree that the use of ratings in this context is a second order issue as they do not determine risk weights. So we suggest that their use also be preserved for the identification of eligible financial collateral.

- Q23. What are respondents' views on the recalibrated supervisory haircuts shown in Table 4? What are respondents' views on how to eliminate references to ratings from the supervisory haircuts table? What could be the implications of eliminating references to external ratings?

We note that the supervisory haircut percentages are generally higher than those applied by our members today in their inventory funding, particularly for equity trades. This problem is exacerbated as netting is not recognised, as we believe it should be.

Many banks use supervisory haircuts for exposure calculation under both the standardised and IRB approaches. The elimination of ratings will make haircuts less transparent and intuitively understandable so it is our preference that for supervisory haircut determination external ratings should be retained. Removing external ratings would also make haircut determination more complicated and could lead to greater variability in RWAs.

Eligible credit protection providers

- Q24. What are respondents' views on the proposed corporate guarantor eligibility criteria?

The proposed changes will add greater complexity to the determination of corporate guarantor eligibility and we recommend that reference to ratings should be retained.

Credit derivatives which do not include re-structuring language should continue to be eligible credit risk mitigants; the presence or absence of re-structuring language largely depends on the bankruptcy laws and approaches in different jurisdictions.

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