

A response by the British Bankers Association to the Basel Committee on Banking Supervision's second consultative document on:

Revisions to the Standardised Approach for credit risk

March 2016

Introduction

The BBA is pleased to respond to the Basel Committee's second consultation paper 347 on Revisions to the Standardised Approach for credit risk¹ and welcomed the opportunity to engage at the recent outreach meeting with the Task Force in Basel as part of IBFed delegation.

The BBA is the leading association for UK banking and financial services representing members on the full range of UK and international banking issues. It has over 200 banking members active in the UK, which are headquartered in 50 countries and have operations in 180 countries worldwide. Eighty per cent of global systemically important banks are members of the BBA, so as the representative of the world's largest international banking cluster the BBA is the voice of UK banking.

All the major banking groups in the UK are members of our association as are large international EU banks, US and Canadian banks operating in the UK as well as a range of other banks from Asia, including China, the Middle East, Africa and South America. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum from deposit taking and other more conventional forms of retail and commercial banking to products and services as diverse as trade and infrastructure finance, primary and secondary securities trading, insurance, investment banking and wealth management.

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.

BBA members include banks headquartered in the UK, as well as UK subsidiaries of EU and 3rd country banks. All of our members including smaller banks currently using the standardised approach as well as larger IRB banks for which, in relation to some portfolios, the standardised approach may provide a floor, have a keen interest in ensuring that the revised standardised approach to credit risk accurately reflects risk in different portfolios in a more granular way. So our objectives mirror those of the Basel Committee. This response represents the views of all our members.

¹ <http://www.bis.org/bcbs/publ/d347.pdf>

In responding to the consultation paper we provide some key messages before providing more granular observations on the consultation paper.

Key messages

We present some key messages based on our review of the Basel Committee's proposals.

Development of the Basel Committee's thinking

We were pleased to be able to comment previously on the Basel Committee's Christmas 2014 consultation on revising the standardised approach to credit risk calculation². We welcome a number of important revisions including the restoration of the ability of banks to use external ratings and the removal of the proposed debt service coverage factor from the residential mortgage risk weighting methodology.

We support the proposal for increased sensitivity as the standardised approach will become significantly more important to the capital allocation process should the proposals be used to calculate capital floors.

We look forward to continuing our dialogue with the task force, building on the recent outreach meeting in Basel which was a helpful exercise and enabled us to take forward our discussions on a number of areas which remain of concern to us.

Risk Sensitivity

Our members support the Basel Committee's objective to improve the risk sensitivity of the Standardised approaches to Credit Risk. This is important for the risk-based capital framework so that the capital which banks hold against their exposures reflects the risk of loss. For exposures where significant levels of security have been taken, the capital requirements should be calibrated to appropriately reflect the credit risk mitigation undertaken. Banks should be encouraged under the capital framework to perform such risk-reducing activity. This is particularly the case for real estate lending, where the value of the property security and other risk mitigants should be considered in the risk weight specified for such exposures.

Our members believe that there are a number of missed opportunities in the proposals where risk sensitivity could be further increased, maintaining acceptable levels of comparability, for example the undifferentiated risk weights applied to specialised lending and acquisition, development and construction (ADC) exposures.

Calibration

Many of our members, large or small, are fully engaged in completing the Quantitative Impact Assessment (QIS) and we look forward to a better understanding of the likely impact of the revised proposals on overall levels of bank capital held against credit risk. We support the Committee's stated objective of ensuring that the aggregate level of capital held against credit risk does not increase but is deployed in a more risk sensitive way to ensure capital is more closely matched to the riskiness of the assets it supports.

² <https://www.bba.org.uk/policy/financial-and-risk-policy/prudential-capital-and-risk/credit-risk/bba-response-to-the-basel-committee-on-banking-supervisions-consultation-on-revisions-to-the-standardised-approach-for-credit-risk/>
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We think it will be important that, as the debate continues about the relevance of flooring IRB approaches, the Committee shares the results of the QIS with industry at an early stage and would appreciate confirmation from the Committee that this is its intention.

Implementation

Depending on the outcome of the Committee's ongoing deliberations on the refinement of internal modelling approaches, which we support, we understand that, under the proposed capital floor, banks using the IRB approach will also have to recalculate their exposures for floor comparison purposes, using the revised standardised approach. So these changes will need to be implemented by both Standardised and IRB banks.

We encourage the Committee to engage with the industry so that it can understand the implementation challenges in order that an appropriate transition period can be identified. Given the likely changes required to systems, data, processes disclosure and, for some, capital requirements, it is likely that banks will require an implementation period of no less than three years from the point of adoption into national law.

Supporting new housing development

The world's population continues to grow and has increasingly high expectations about the standards of its habitable buildings. The banking industry is determined and committed to playing its part in increasing and improving the housing stock by supplying finance to providers of residential homes.

The Committee's proposals in relation to the financing of Buy-to-Let (BTL) housing and ADC financing will substantially increase the capital requirement for such socially important lending activity with consequent impacts on the cost of such lending and the availability of the new housing stock it finances. It will also impact lifetime mortgages which have a role to play as an ageing population is faced with financing long term health care provision.

Furthermore we do not agree with the Committee's view that BTL lending is substantially riskier than the financing of owner-occupied residential property, in our view the risks are not dissimilar at Loan-to-Value ratios below 80%.

We propose the creation of a subset of ADC lending – residential real estate under development / construction - as we do not believe such exposures merit a 150% risk weighting. A more refined slotting approach would facilitate a proportionate risk-based approach, one which could be adapted to ratchet down risk weighting as an ADC project moves towards completion.

Credit Conversion Factors

The removal of the 0% credit conversion factor (CCF) for Unconditionally Cancellable Commitments (UCC) does not reflect the actual risks of such exposures given that banks can and do cancel such commitments in practice. Where consumer credit requirements or other legal constraints would actually prevent cancellation of commitment they would not be classified as UCC in the first place, but instead as general commitments. Neither do we agree with the removal of UCC conversion factors to non-retail commitments where both legal and practical considerations allow for

cancellation in particular where each drawing must be pre-approved, giving the bank the opportunity to exercise its right to cancel.

In our view a single CCF for other non-balance sheet items in the range 50% to 75% is not appropriate as it does not reflect the differences in drawdown risk between product types. Again we would be pleased to work with the Committee as it considers this approach further, perhaps by introducing a more granular taxonomy that would enable a wider range of CCFs to be applied.

We appreciate and support the committee's interest in establishing a level playing field for banks in respect of CCFs. The best way to harmonise the CCFs would be to carry out a full review for the Standardised and FIRB approaches as a separate item, in the same way that the Sovereign review is being kept separate.

Defaulted exposures

We support the alignment of the standardised definition of default with the more sophisticated IRB approach to identifying defaulted exposure.

Due diligence

We note that a bank using an ECAI's external ratings will have to conduct its own due diligence to understand the uses and limitations of external ratings in order demonstrate that it is not mechanistically relying on them. We support this, but recommend that in order to fully mitigate this risk, a bank should be allowed to assign lower risk weights should their due diligence determine this to be is appropriate.

We request further clarity as to the extent of the due diligence that the Committee intends. We envisage a high level approach that examines the outcomes of the ECAI methodology, in order to determine whether the ECAI's external rating is consistently aligned with the bank's own view and the proportion of downwards-only overrides that it has applied. This approach could perhaps mirror/build on the review that will be undertaken by national supervisors in recognising an ECAI's ratings as being eligible for regulatory purposes.

We do not expect that the due diligence process will require banks to build a quasi-IRB modelling system to satisfy the due diligence requirement. This would unduly penalise smaller banks which are unlikely to have this capacity.

It would also be helpful to understand how mutual recognition of ECAI eligibility would be determined.

Comments on the proposed revisions to the standardised approach for credit risk by exposure type

In the following section we comment in a more granular way on the proposals as they apply to different exposure classes.

Banks

We welcome the proposal that banks should be able to use external ratings to assess the credit risk of its exposures to another bank. Where a counterparty bank is unrated or a bank is established in a jurisdiction which does not permit the use of ratings for regulatory purposes we agree that the three bucket approach is a suitable alternative. It is based on mandatory quantitative criteria covering capital, liquidity and leverage ratios. We are pleased that the Basel Committee has recognised that not all jurisdictions may implement the Basel II and III requirements in the same way - for instance some may not yet include liquidity metrics - and that the relevant quantitative criteria refer to those as implemented in the jurisdiction of the borrowing bank. We request clarity on the Standardised Credit Risk Assessment Approach definitions, particularly Grade A and B, as the proposed text could be interpreted differently by banks. For example, Grade A requires the bank to exceed the published minimum regulatory requirements while for Grade B they need to be met. The distinction between meeting and exceeding minimum regulatory requirements is unclear. In our members' opinion any bank which meets all the published minimum regulatory requirements should be classified Grade A.

We support the Committee's desire that ratings used for regulatory purposes should exclude government support and note that a number of ratings agencies have moved, or are moving, towards publishing ratings with and without government support. We do not envisage this presenting a problem providing a reasonable period of time is allowed for implementation, during which time ratings agencies will be able to adjust their methodologies where necessary. As a result of the removal of government support from external ratings we recommend aligning the external rating to risk weight mappings across the bank and corporate exposure classes.

We appreciate that the Committee proposes to retain a preferential risk weighting for short term exposures although recommend that this be based on remaining maturity, not initial maturity, to reflect the reality of the nature of the 'point-in-time' exposure.

Corporates

Large corporate lending

We support the ability of banks to use external ratings to assign a base risk weight to their corporate exposures and the Committee's stated intention to review the calibration of risk weights based on the latest QIS submission. The proposed standardised risk weights for AAA to BBB- rated corporates are not reflective of members' internal experience.

We request clarity on the intended use of external ratings within a corporate group under paragraph 100. We understand this to permit a parent rating to be cascaded – potentially with notching reflecting the level of support - to a wholly owned unrated subsidiary, but not a subsidiary rating to another unrated subsidiary in the group.

We support a more granular approach to corporate exposures through the introduction of a SCRA approach for unrated Corporates similar to that proposed for banks in jurisdictions that do not allow

the use of ratings. We note that a 75% 'investment grade' risk weighting would be available and that one of the criterion in defining 'investment grade' is that the corporate entity or its parent should have securities listed on a recognised securities exchange. We recommend the same consistent treatment of unrated corporates, between jurisdictions permitted / not permitted to recognise external ratings, as afforded for unrated banks; this would make the 75% "investment grade" corporate risk weight available for use in all jurisdictions.

Finally, we recommend the risk weight calibration for BBB rated corporates does not exceed the risk weight assigned to unrated "investment grade" corporates (proposed as 100% vs 75%) to promote consistent capital allocation to the same counterparties in jurisdictions permitted and not permitted to recognise external ratings.

SME lending

We note that it is proposed that SME lending that is not managed on a portfolio basis attracts a higher, 85% risk weighting than portfolio managed SME exposures which are weighted at 75%. We see no fundamental difference between these two SME sub-classes. Indeed it is arguable that failing relationship-managed SME loans can be identified at an earlier stage and remedial action, including loss mitigation by the taking of physical security, taken to reduce any eventual loss. We recommend all SME lending be risk weighted at 75%.

Other Corporates

Unrated corporates not meeting the investment grade or SME definitions will be assigned 100% risk weight under the proposed rules. This will in practice be applied to medium-sized corporates and we recommend that the ultimate risk weight calibration of this category should not result in an inconsistent capital treatment, and unintentionally reduce supply of credit to this sector, compared to the proposed standardised risk weighting of unrated SMEs and Investment Grade Corporates.

Specialised lending

We support the proposed use of external issue-specific risk weightings for specialised lending and the use of IRB definitions to identify specialised lending which is, broadly, an exposure to a special purpose entity. However, we would note that the majority will not have ratings and therefore flat risk weights could become the norm. The flat risk weights do not recognise the structure and collateralised nature of such deals, which give the lender control over the asset(s) financed and the cash flows they generate. As a result assigning risk weights that are the same or higher than those attributable to unsecured corporate lending does not effectively rank-order the risk in this lending. We would suggest the Committee look to incorporate IRB slotting in full or part. This would meet the committee's objective of risk sensitivity and comparability with IRB.

Finally we welcome the recognition that the risk profile of project finance reduces as the underlying project is completed, an approach we suggest could also be used in a modified form in ADC finance.

Real estate

The introduction of a more granular LTV risk weighting profile and the removal of Debt Service Cover as a second factor in assessing riskiness is welcomed. The Committee's proposals in relation to real estate are of the most concern to us, particularly in relation to Social housing, BTL lending and ADC

finance. All of these types of lending support the UK and many other governments' commitment to increase and improve the supply of housing within their countries; bank lending is a core source of financing for this sector.

Property valuation

We believe it is in the interest of risk sensitivity that current market value be used in the calculation of LTV. This would make the risk weight more sensitive to the underlying value of the bank's portfolio and the age of its stock of loans. If the current proposal to retain origination value throughout the duration of a loan were left unchanged it could create unnecessary book churn as borrowers are incentivised to re-mortgage in order to release capital built up as house prices increase – incurring avoidable additional costs in the process.

We request footnote 46 be clarified to require the property valuation to be conducted by an independent party. The current wording could be read to mean any valuation conducted at the time of the bank's mortgage acquisition, loan processing or loan decision process is not permitted to be used in the LTV.

Absolute risk weights applied

In the experience of our IRB members in the UK market, the risk weights proposed overestimate the risk of residential real estate and will result in an increase in capital which is contrary to the stated objective. At present the proposals are particularly penal for portfolios with more conservative LTV profiles.

The level of over estimation should be addressed by reducing risk weights across all LTV buckets, the risk sensitivity of the approach should be further enhanced by reducing risk weights proportionally for low LTV exposures, and also introducing additional buckets for exposures with LTVs below 30%.

Appropriate recognition of security

The security taken against low LTV exposures will provide significant credit risk mitigation which should be reflected in risk weighting. Such an approach would provide an appropriate incentive to banks to improve levels of security made against such lending, but also narrow the potential for standardised risk weight to diverge from observed experience for low LTV.

With regard to risk weights for IPRE (table 9), we cannot see a justification for secured lending to have risk weights higher than those applied to unsecured Retail exposures.

Blended risk weights

To avoid cliff effects we would recommend that a progressive approach is used for allocation of risk weights by LTV whereby lending up to 40% of the value receives a risk weight of 25%, the next 20% of lending would receive a 40% risk weighting and so on. In this way a blended risk weight is allocated to the total exposure which is more reflective of the true comparative risk of exposures around LTV margins. This would also address the risk weight inconsistency for high LTV mortgages which it is proposed should receive the same 75% risk weight as unsecured retail lending, ignoring the risk mitigating effect of the real estate collateral. We recognise that originating mortgages with an

LTV greater than 100% is risky and would be discouraged by a high risk weight but urge the Committee to consider the implications of this in a downturn, where property prices are revised downward, and the impact it will have on borrowers moving into this category who originated loans with an LTV below 100%. This would particularly impacts first time buyers in the UK who are typically characterised by high LTV lending and conflicts with UK Government policy to support homeownership through the Help-to-Buy scheme as it would significantly increase their cost of borrowing during a downturn.

Finally, we recommend a change to footnotes 48 & 51 which assign an 85% risk weight to Retail SMEs where LTV >100% as this is a higher risk weight than assigned to unsecured Retail SME lending.

Residential real estate where repayment is materially dependent on cash flows generated by the property

We understand the definition of IPRE applies to BTL when repayment of the lending is materially dependent on cash flows generated by the property and would apply to all jurisdictions regardless of the sophistication and maturity of the market and financial quality of the landlord. We recommend the revised rules should allow for jurisdictional specificities by allowing a national discretion for regulators to permit a specific type of lending to receive the general treatment where they have evidence of a well-established residential property market, with readily available market prices and low observed loss rates. As we note below such a determination has been made by the UK's Prudential Regulation Authority.

We also request further clarity on the definition of "materially dependent", paragraphs 56 & 60, in order to ensure a consistent approach between banks and jurisdictions.

UK BTL properties are collateralised in the same way as mainstream residential mortgages. A residential property is an exceptionally strong form of collateral regardless of the nature of the loan made against it. Robust BTL lending that takes into account the high financial quality of the landlord is, we suggest, little different in its risk profile when compared with mortgage lending to owner occupiers. In general, a well-managed BTL portfolio has a comparable risk profile to owner-occupied residential real estate particularly for Loan-to-Value exposures below 80%. The differential between the proposed risk weightings for owner occupied and BTL real estate exposures is certainly disproportionate to any small difference in underlying risk.

The table below is extracted from the PRA's consultation paper on Pillar 2³ and supports our view.

Loan to Value	<i>Current standardised risk weights %</i>	Prime Mortgages <i>Average IRB risk weights %</i>	Buy to Let <i>Average IRB risk weights %</i>
< 50%	35	3.3	3.5
< 60%	35	5.1	8.2
< 80%	35	10.8	17.5
< 90%	36	18.4	32
/< 100%	43	31.4	43.1

³ <http://www.bankofengland.co.uk/prd/Documents/publications/cp/2015/pillar2/cp115.pdf>
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It is accepted that a key indicator of mortgage probability of default is the unemployment rate. So the ability of the owner occupier to service her or his mortgage or the BTL occupier to continue paying the rent that will allow the ultimate owner to service the associated loan are both based on the same underlying factor, whether or not they are in employment, which is itself linked to the macro-economic state of the economy. Stress testing and the countercyclical buffer are already supervisory tools that take into account the possibility of a period of economic stress impacting default rates and loan recoveries. Imposing such high risk weights on BTL lending would in our view introduce an element of double counting.

In the UK the regulation of the private tenancy market makes it easier for the landlord to gain vacant possession of a BTL property than an owner occupied one financed via a conventional residential mortgage. So a BTL property can be made available for new tenants and the source of repayment re-instated quite rapidly. BTL borrowers often have a small portfolio of properties so are able to make required loan payments because of the diversification of their source of rental income which covers them in relation to individual tenant specific problems. Lenders also take into account not only the ability of the BTL rentals to cover repayments but also the credit worthiness of the individual landlord.

This is reflected in the determination by the PRA, in its Supervisory Statement 10/13⁴ that the UK has a well-developed and long-established residential property market with sufficiently low overall write-off levels to justify risk weighting such exposures on the same basis as exposures where repayment is not materially dependent on cash flows generated by the property.

We believe the Committee should re-evaluate the proposed risk weighting in the table at paragraph 55 of Annex 1, and in particular allow such lending to use the risk weighting of Residential owner occupier residential lending where there are features of the lending that reduce risk to levels comparable with Residential owner occupier residential lending.

The only difference between such interest only mortgages and Residential owner occupied residential lending is the end of term position and, in our experience, end of term losses are very low.

In our view, and as stated in section 1.5 of the consultation paper, exposures where repayment is materially dependent on cash flows generated by property are Income Producing Real Estate. We question whether owner-occupied lifetime or interest only mortgages where repayment is dependent on the sale of the property should be included in this category. The inclusion of lifetime mortgages in BTL would impact an increasingly important tool to finance long-term healthcare.

It is also important to clarify that Housing Associations / Social Housing should be included in the exclusion from the approach for repayment materially depending upon cash flows generated by the property. Footnote 50 to paragraph 56 should be amended to make this clear.

Definition of ADC

We request clarification on the intended definition of the ADC category which includes “loans to companies or individuals to finance the acquisition of finished property where the repayment of the loan depends on the future uncertain sale of the property”. We believe this definition is intended to capture speculative investment property lending – i.e. repayment of the loan is from the proceeds

⁴ <http://www.bankofengland.co.uk/pradocuments/publications/ss/2013/ss1013.pdf>

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from the uncertain future sale of the property. However, we are concerned the current definition can unintentionally be read to include interest-only products used to finance less risky borrowing which should, in our member opinion, qualify for the general treatment or IPRE – for example to UK Housing Associations, BTL and owner-occupier mortgages. Further, the focus on “future uncertain sale” ignores the benefits of the secured nature of this lending, particularly for residential development where proven rental income provides further mitigation.

In terms of residential property development lending we are concerned that “future uncertain sale” is inadvertently being used as a proxy for “speculative” which would be misleading because property developers will not as a matter of course be relying on increased house prices to justify their development (and where they are, this could readily be addressed as part of an enhanced slotting approach we propose below).

As such, we also request further clarity on the definitions of “future uncertain sale” and “substantially uncertain cash flow” in order to ensure a consistent approach between banks and jurisdictions.

Development property

In the experience of our members different types of ADC poses different levels of risk. For example an asset in the form of out of shopping outlet on a retail park could have a high value if occupied by a first class tenant on a long lease. However the same asset unoccupied could have little or no value. By contrast a residential property in locations where there is an acknowledged shortage of housing stock will always have an inherent value. This is one reason why lending against commercial property in the UK has historically been more problematic than residential house building finance. We believe residential property and commercial property lending should to be differentiated for the purposes of risk weight and propose the establishment of a new exposure class – residential real estate under construction – to accommodate this difference.

We would strongly suggest revisiting the approach and risk weights for residential development property. Currently residential real estate development does not meet the paragraph 50 requirement for finished property and it is proposed to assign a 150% risk weight under the ADC category. Such penal treatment will severely impact the flow of finance to support the provisions of new and improved homes, which is properly a universal objective of governments in all parts of the world. In the absence of such private finance the burden of providing and funding new housing will fall to central or local government, which in our view is a sub-optimal solution, as it removes the benefit of competition in optimising building costs and providing the external scrutiny that private finance and construction brings.

We recommend revising paragraph 50 to permit the LTV risk weight approach for residential development property and a recalibration of the 150% ADC risk weight based on QIS results, as it is inconsistent to assign a higher risk weight to a secured exposure when an unsecured corporate exposure receives 100%.

We therefore propose the splitting of the ADC into residential and commercial sub-categories. This would allow a stepping-down of risk weightings of ‘residential real estate under development / construction’ as a development moves towards completion, mirroring the approach in the project finance specialised lending sub-class.

This could be achieved by a slotting approach that would take in to account factors such as loan to gross development value, the progress of the project as it nears completion, demand for residential housing in the local area, the extent of pre-sales supported by paid up deposits and relying on specialist expert opinions where appropriate from surveyors and estate agents. Risk weighting would decrease from 150% to close to residential retail exposure risk weights as the project matures. A similar approach is adopted in the US by the FDIC which has issued helpful 'FAQs' on this topic in relation to the scope of 150% risk weighting of HVCRE loans⁵.

We are also concerned that ADC finance secured by land should not encompass lending to the farming and forestry business. Their loan profiles and the way in which banks manage such exposures are more akin to corporate lending or, in some cases, specialised lending. A 150% risk weight is not merited and we suggest a 100% risk weighting for such exposures.

Subordinated debt, equity and other capital instruments

The application of a flat 250% risk weight for non-deducted equity exposures is insufficiently risk sensitive and consideration should be given to increasing granularity in this area. One option could be to revisit the Simple Risk Weight approach under IRB, proposed in 2014, which could be leveraged for the standardised approach. It is important that all three categories recognised under CRDIV are utilised, differentiating private equity, exchange traded and other, with suitably calibrated risk weights, given the current risk weights would be disproportionate to the underlying risk.

Credit Conversion Factors

We understand the Committee's desire to remove the application of credit conversion factors (CCF) of 0%.

However we believe that the factors the Committee cites as informing its view that higher CCF are required – consumer protection laws, risk management capabilities and reputational risk – will vary by jurisdiction, depending *inter alia* on the legal environment and local banking practice. In our view such risks are not suitably captured through Pillar 1, where capital requirements should be set based upon the underlying contractual restrictions around cancellation. Any perceived risk over and above the true credit risk would be better addressed via a Pillar 2 methodology applied by individual regulators in the light of their local knowledge.

Unconditionally cancellable commitments

In particular we do not believe that retail unconditionally cancellable commitments (UCC) merit a CCF in excess of 10%. A proportionate increase to 10%, which is our recommendation, also aligns it with the approach in the leverage ratio requirements which creates a helpful and coherent alignment between the two regimes.

It is not appropriate for UCC CCFs to be applied only to retail customers. A number of corporate facilities and products are provided on an uncommitted basis and are cancellable both contractually and in practice through frequent review of limits and pre-approval of any drawings. Given this, the UCC CCFs should be available to corporate counterparties. Without this, significant and disproportionate effects will be observed for SME lending and for the trade finance sector.

⁵ <https://fdic.gov/regulations/capital/capital/faq-hvcre.html>

Other off balance sheet items

We note that the Committee proposes to apply a CCF in the range 50% to 75% for general off-balance sheet (OBS) commitments based on its analysis of the 2015 QIS results. This proposed CCF approach is not granular enough to provide the gradations of CCFs that we believe is necessary. This could be improved by a more detailed OBS product taxonomy that could be used to assign lower CCFs to OBS exposures that are genuinely at the lower end of the risk spectrum.

We recall that the design of the relevant section of the QIS will have masked the range of loss experience of different types of OBS exposures. We recommend the forthcoming QIS is designed to capture these different aspects.

In particular we believe that the proposed CCF range will significantly impact trade finance activity that is so important for our smaller customers whose exports support new jobs and economic growth.

The sorts of trade support activities we have in mind include:

- lombard finance facilities which can often be used to provide bridge finance to small business owners;
- letters of credit issued or confirmed and related undertakings;
- pre-shipment and post-shipment acceptances and/or financing⁶;
- trade loans;
- performance guarantees, bid bonds and other guarantees (including standby letters of credit that do not have the characteristics of a credit substitute).

provided these transactions are:

- not part of the firm's ongoing financing of the obligor.
- connected to the exchange of goods or services.

The important distinguishing feature about all such trade support activities is that a bank will not renew finance automatically. It will always make a positive decision to extend further finance and is fully capable of declining to do so. So we propose that where a bank has proper systems and controls in place, supported by robust legal documentation, a bank should be able to apply a 10% CCF to such trade support facilities.

We have already noted above the unwarranted impact of the proposals on ADC financing. Given that phased or staged lending is an integral component in lending to property developers, from both a commercial and from a risk management perspective, then these undrawn commitment proposals will further exacerbate the impact of lending to this socially important industry.

⁶ BAFT-IFSA definitions of pre-shipment and post-shipment financing are:

1. **Pre-Shipment financing**, also known as Purchase order financing, is made available to a seller based on a purchase order received from a buyer. This financing can cover all the related working capital needs of the seller including raw materials, wages, packing costs and other pre-shipment expenses. Once the goods are ready, refinancing or repayment can occur.
2. **Post-shipment financing** is provided to a seller using the receivable as collateral. The seller presents shipping documents as evidence of a receivable and the bank may also require a bill drawn on the buyer for the goods exported. The bank may prefer to purchase and discount a bill drawn on the buyer for the goods exported.

We appreciate and support the committee's interest in establishing a level playing field for banks in respect of CCFs. However, given the split of methodologies used, increasing the CCF for standardised banks while leaving Foundation IRB (FIRB) CCFs unaffected does not resolve the potentially significant imbalance between banks using different regulatory prescribed approaches. The best way to harmonise the CCFs would be to carry out a full review for the Standardised and FIRB approaches as a separate item, in the same way that the Sovereign review is being kept separate.

In conjunction with the broader review of modelling approaches for low default portfolios, data used to support AIRB approaches for low default portfolios such as Financial Institutions and Large Corporates should be combined with other appropriate data to calibrate regulatory CCFs under the Standardised and FIRB approaches. This would achieve a more consistent and risk sensitive framework across the three approaches.

Our members are also concerned that changes to CCF thresholds will impact Leverage calculations, and may need further recalibration as a result.

Defaulted exposures

As noted above, residential real estate exposures where repayment is materially dependent on cash flows generated by the property are collateralised in the same way as other residential real estate exposures. We therefore do not see the justification for risk weighting such defaulted exposures in the same way as defaulted unsecured exposures.

Currency mismatch

We were surprised that the second CP included corporate exposures in the set of exposure types that would be subject to a 50% currency mismatch RWA uplift. Banks and rating agencies already take FX risk into account in their assessments and corporate treasuries in our view are fully conversant with the risks for their business of unhedged currency exposures and have a variety of tools with which they can mitigate such risk.

Creating an add-on will create operational issues around the processes for assessing whether or not a natural or legal hedge exists, the costs of which will, in our view, outweigh the benefits.

We further note that a 50% add-on would mean that lending to an unrated corporate on a cross currency basis would receive the same risk weighting as an exposure in default.

We believe that the proposal as worded inappropriately penalises counterparties with significant income or assets in the currency of the exposure where it is not the currency of their *main* source of income. In many cases assets or other income denominated in the loan currency could be used to service and repay the loan. Banks should also be allowed to consider prospective income derived from the asset which the loan will be funding in this context. We recommend that the increased weighting need only be applied where there are insufficient assets or income in the exposure currency.

We further note that a 50% add-on would mean that lending to an unrated corporate on a cross currency basis would receive the same risk weighting as an exposure in default.

Credit risk mitigation

Removal of models

The proposals would remove the current possibility that firms have to use the Internal Model Method (“IMM”) or Value at Risk (“VaR”) to calculate counterparty exposures for Over the Counter (“OTC”) derivatives and Securities Financing Transactions (“SFT”) under the standardised approach. We strongly disagree with this proposal as it would significantly increase capital requirements for impacted firms which we believe is not the intention of the BCBS.

There is no fundamental logic to link IMM or VaR approval with IRB approval.

It is important to recall that internal credit risk modelling (i.e. IRB approaches) and IMM or VaR modelling have different purposes and are based on different data and assumptions.

Investment in IRB modelling methodology may not be warranted for firms with a trading focus and a limited lending business. For such firms with predominantly low default portfolios, exposure modelling (IMM/VaR) rather than IRB based counterparty default modelling is more important from a risk management perspective. Where these standardised approach firms enhance their risk management and measurement capabilities by developing market risk modelling methodologies for their trading book positions and OTC/SFT counterparty exposures and meet the high approval standards and stringent back testing requirements required to obtain permission to use these models in their RWA calculations, these permissions should remain. Withdrawing the possibility for these firms to use their IMM or VaR models would reduce incentives for firms to invest in risk measurement methodologies. We urge the BCBS to reconsider this aspect of the proposal.

We are concerned about the proposal to create a dependency between a firm’s ability to receive permission to use own estimates and Internal Model Method (IMM) approaches for calculating counterparty credit risk capital requirements, with holding an Advanced or Foundation IRB (A/FIRB) permission. In addition, there are concerns that the overall level of sophistication in the CRM framework has been reduced through the proposals in this consultation.

Fundamentally, we do not believe it is appropriate to assume a firms’ ability to model exposure value for counterparty credit risk – whether that be through own estimates or the internal model method approach – is bound by its ability and motivation to produce A/FIRB compliant PD and LGD estimates.

The volume of market data available to the firm, the capability of its modelling and independent validation functions available for modelling robust exposure values for counterparty credit risk and collateral management processes can and should be considered in isolation of the equivalent criteria for determining individual counterparty parameters for PD and LGD. This principle applies universally across firms with trading books, however is particularly relevant for those firms dominated by the trading books and a limited banking book – where the benefits of increased risk sensitivity realised through the A/FIRB approaches do not outweigh the costs.

It is correct and appropriate that the regulatory provided values which provide the Standardised equivalent of the PD and LGD parameters are used where A/FIRB permissions are not held.

The purpose of the Committees' standardised approaches is to provide simplicity and comparability via a base level of regulatory requirements – acknowledging that where firms and jurisdictions are able to meet more advanced standards, then these permissions are granted.

The imposition of this dependency precludes a firm's ability to demonstrate compliance with the own estimates and IMM requirements and should therefore not be persisted in the final requirements.

As with other areas of the consultative document, there is also a need to consider the implications of forthcoming BCBS proposals in the area of IRB modelling together with these suggested changes. Removal of certain portfolios from IRB would result in exclusion of these portfolios from IMM or VaR as a result of the interaction with the SA proposal, further increasing capital requirements across the industry to the detriment of certain lending activity.

Conclusion

We welcome the Committee's improvements to its original proposals to revise the standardised approach to the calculation of credit risk. We welcome too the Committee's clear statement of its objective that the overall level of capital in the banking system should not increase.

But believe that a number of areas warrant further refinement with the objective of making the standardised approach more risk sensitive and more closely aligned to banks actual loss experience. In particular we believe that further consideration should be to be given to the treatment of a number of elements of real estate exposure risk weighting and aligning the treatment of exposures to different types of SME and mid-size corporate credit risk exposures.

We would of course be delighted to discuss our response with the Committee in due course and importantly look forward to early engagement with it as soon as the results of the QIS are known in order that the appropriate calibration of the standardised approach can be achieved.

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