

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
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Credit Suisse response to the Second Consultative Paper on 'Revisions to the Standardized Approach for credit risk' (BCBS 347)

Credit Suisse AG ("CS") would like to thank the Basel Committee on Banking Supervision (the Committee) for the opportunity to comment on the second consultation paper 'Revisions to the Standardized Approach for credit risk' (BCBS 347). We are fully supportive of the Committee's objectives for revising the standardized approach to credit risk but would urge the Committee to give full consideration to the responses from CS and other industry participants.

CS played an active role in, and fully supports, the response and key findings to the consultative paper provided to the Committee by the International Institute for Finance, the Global Financial Markets Association, the International Swaps and Derivatives Association, and the International Association of Credit Portfolio Managers, together the "Joint Association". Outlined below are the themes in the Joint Association's response that CS believes are the most important for the Committee to consider. In addition, we provide more detailed responses to the individual issues we deem significant in the consultation paper in the Appendix to this letter.

- **Specialized Lending** – The proposed approach uses flat risk weights in each category of specialized lending and does not reflect the true risk sensitivity of various types of lending and associated collateral. Recognition of additional risk sensitivity in this area would lead to a more rational outcome and should lead to additional and safer lending opportunities.
- **Increase in Off-Balance Sheet Credit Conversion Factors** – The proposed approach results in material increases in credit conversion factors for off-balance sheet exposures, particularly for lending commitments regardless of revocability or maturity. We feel that the increased cost for our clients to secure financing will limit the flexibility to manage their business.
- **Use of External Credit Assessments** – We appreciate the Committee's reintroduction of external credit ratings in the current proposed approach. However, there is still a lack of risk sensitivity between jurisdictions that allow external credit ratings and those jurisdictions that do not. This is particularly significant for unrated corporate exposures, including small and medium size entities, as well as low risk fund-type vehicles.
- **Unrated Intragroup Exposures** – Unrated intragroup exposures will be significantly impacted in the calculation of risk weights at a stand-alone reporting entity level within a consolidated group and should be specifically addressed within the standardized approach rather than default to an unrated corporate exposure if it does not meet the definition of a bank.

The changes proposed in BCBS 347 are not happening in isolation, but in parallel with a major overhaul of the regulatory capital framework. We therefore encourage the Committee to adopt final rules only once a holistic QIS has been completed and following an assessment of cumulative impacts taking into account the forthcoming rules on capital floors. This will allow the Committee to fully understand the overall impact of the proposals and help to ensure the final rules fulfill the Committee's intended result, and do not lead to aggregate capital increases across the banking sector.

Yours sincerely,



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APPENDIX - Detailed CS comments

External Credit Ratings vs. Other Factors

We are grateful that the Basel Committee has acknowledged industry feedback in their latest draft rules. In particular, we support the reintroduction of external credit ratings as they are an important source of information that take into account many more risk drivers, including the counterparty's liquidity, leverage, income, etc. However, unrated corporate exposures in jurisdictions that accept the use of external ratings will receive a flat 100% risk weight, with the exception of small and medium entities (SME) where an 85% risk weight will be applied. For unrated corporate exposures in jurisdictions that do not accept the use of external rating, a 100% risk weight is applied, with the exception of investment grade corporates that meet the definition of investment grade based on an internal credit assessment. These jurisdictional differences for unrated corporate exposures should be aligned by applying the same approach as used for unrated bank exposures under the Standardized Credit Risk Assessment (SCRA) approach.

In addition, the definition of "investment grade" is too vague leading to undesired incomparability between banks and across different jurisdictions. The majority of corporate exposures would fall under the current definition of investment grade, but would create a disadvantage for jurisdictions accepting external ratings (risk weighted at 100% for unrated corporate exposures) versus jurisdictions that do not accept external ratings (risk weighted at 75%). As a large portion of our corporate credit exposure is to externally unrated companies and SMEs, we are surprised that no alternate treatment is part of the proposal. We favour the incorporation of an internal analysis of unrated corporate exposures, the same as used for unrated bank exposures, to create a more risk sensitive revised standardized approach. In practice, we observe a wide range of internal ratings based (IRB) approach client ratings, excluding collateral, for this lending segment and are not in favour of one flat risk weight.

Comparability across Jurisdictions

We believe it is important to promote comparability and reduce variability in risk-weighted assets across banks in different jurisdictions. It is important that standardised approach promotes a level playing field between institutions located in jurisdictions that do not allow the use of external credit assessments and those that allow reliance on external rating agencies. We disagree that risk weights derived from internal due diligence processes for high quality credit exposures such as Grade A banks, investment grade corporates, MDBs and specialized lending exposures be higher than for exposures with the same credit quality under externally rated jurisdictions. In our opinion, this will harm the value of the internal due diligence process and the added benefit of SCRA approach. We suggest that the methodology used for corporate exposures be aligned with the External Credit Risk Assessment (ECRA) approach and the SCRA approach as used for bank exposures. Additionally, there should be alignment in the risk-weight categories under both the ECRA and SCRA approaches, i.e., include 20%, 50%, 100%, and 150% categories in both approaches. This would allow internal credit assessments used in jurisdictions that do not allow external ratings to be more granular and allow a 20% risk weight currently only available under external ratings of AAA to AA-. Furthermore, in jurisdictions that do not allow the use of external ratings for regulatory purposes, the implementation of the Committee's requirement to exclude government support should be incorporated into existing qualitative rating processes.

Unrated Low-Risk Exposures

Given that regulatory bodies are deliberately constraining the use of internal models, it is important that the inherent low risk of certain low-default portfolios is reflected appropriately through additional risk differentiation in credit conversion factors (CCF) and risk weights. Low default risk businesses like funds, specifically mutual funds and hedge funds both typically not rated externally, receive the same standardized risk weight as other corporates and may be barred from own modelling, regardless of having very different loss potential, specifically in economic downturns.

There are numerous non-bank financial institutions that we believe are investment grade, based not only on their business model, but also based on their leverage and transparency. As an intermediary between capital markets participants, a typical market-making firm has exposures to many “real-money” investment funds (sovereign wealth funds, pension funds, and other asset managers), either through derivative hedges or through forward settling transactions, which also give rise to a potential credit risk exposure. While there are some funds that have relatively small cash investments and would be considered non-investment grade, the real-money funds generally only have risk-reducing hedges (e.g., interest rate hedges) that are a small fraction of their overall cash-based investment portfolio. The absence of externally rated debt issued by the mutual fund should not necessarily lead to an inappropriate treatment under the standardised approach.

We consider many of these real-money investment funds investment grade, and believe a truly risk-sensitive approach to credit risk that would better recognize their stability and creditworthiness. As part of our proposal to use the SCRA approach to unrated corporate exposures, additional factors should be added to assist in distinguishing between speculative funds and real-money funds. Items that could be considered include:

- Overall leverage of the fund,
- Governance of the fund, and
- Benchmarking of performance objectives.

Based on some of these criteria, we propose an identified “real-money” fund would be treated as Investment Grade (or perhaps better) despite the absence of any traded debt (externally rated or otherwise). We would be happy to help provide further information around these types of objective criteria that could be used to meet the Committee objectives.

All businesses can have vastly different risk profiles and external ratings are not generally a feature available for many of them, including non-bank financial institutions, many corporate entities, ship finance, commodity and other trade finance, as well as margin lending. A standard risk weight for all unrated exposures results in a perverse incentive to increase exposures with higher economic risks. The Committee should consider a small number of risk buckets, e.g., strong investment grade, investment grade and noninvestment grade, for unrated exposures, which would strike a better balance between risk sensitivity

Unrated Intragroup Exposures

Banks must maintain capital adequacy at a consolidated group level and at certain stand-alone entity levels within a consolidated group. A stand-alone entity may have significant intercompany exposures to an affiliate within the consolidated group that may not be externally rated. For example, these exposures may include intercompany funding of a subsidiary by the parent or one entity using another entity as a clearing member to access a clearing house for derivative exposures. Where a single entity within a consolidated group is not externally rated and does not fall into the definition of a bank, a 100% risk weight will need to be assigned as an unrated corporate. This is overly conservative and we recommend that specific guidance be included for related companies within groups that are subject to regulatory supervision on a consolidated basis. As an example, Article 113(6) of the Capital Requirements Regulation of the European Commission permits a firm, subject to conditions including supervisory approval, to apply a 0% risk weight for exposures to certain entities within its regulatory consolidation group. For those affiliated entities that do not meet the conditions for a 0% risk weight, an internal assessment approach should be allowed as used under the SCRA approach for banking entities. Such treatment would be consistent with the principles for the standardized approach which should be intuitive, readily available and capable of explaining risk consistently across jurisdictions. We also note that the Quantitative Impact Study (QIS) for the Basel III monitoring only includes the results on a consolidated group level and would not include the impact of intercompany exposures. Hence, the QIS will significantly underestimate the impact of the revision to the standardized approach for credit risk for stand-alone entity capital requirements within a consolidated group.

Secured Lending

There is no recognition that risk is reduced through secured lending that do not meet the requirements of collateralized transactions under the rules for credit risk mitigation techniques. Security is a key factor that increases a bank's ability to prevent default and to collect its funds within terms, and in the event of default security increases likelihood of recovery. Secured exposures should benefit from lower risk weights compared to equivalent unsecured exposures. The non-recognition of collateral in businesses important for global trade seems odd given such businesses work only on the basis of collateral. We feel that all secured lending with justifiably strong security packages on weaker rated corporates should benefit from lower risk weights. An unintended consequence could easily result in less secure forms of lending to maximize returns. In our opinion, the recognition of collateral through a beneficial adjustment to the standard risk weights in both the ECRA and SCRA approaches, or a slotting approach as we describe in the section on Specialized Lending, would be a step forward towards a better standardized approach for secured lending.

Specialized Lending

With the exception of income producing real estate, specialized lending is generally done by larger banks who apply the IRB approach. The risks involved can be very different. Certain specialized lending businesses are structured with valuable collateral, e.g., ship finance and commodity trade finance which often have a liquid market. The proposed flat risk weights do not reflect the real risks to the bank and make such lending unviable under standard approach floors, which in turn hampers global trade and production. Treating secured and unsecured exposures the same creates a perverse incentive towards riskier lending practices. Recognition of risk sensitivity in this area would lead to a more rational outcome and should lead to additional and safer lending opportunities for the real economy. There is less risk to secured borrowers compared to unsecured borrowers and a lower risk weight should be available for secured lending. Empirical data from Global Credit Data indicates actual LGD and loss rates more commensurate with a substantially lower risk weight on average for each line of specialized lending.

We therefore propose to include the value of such collateral, namely traded commodities, ships, aircraft, etc. as risk weight reducing, similar to income producing real estate exposures. For example, collateral such as an oil tanker or often presold commodities should be given value if the credit risk mitigation operational requirements are fulfilled. This could be done by a risk weight differentiation following a slotting approach, taking into consideration the value of collateral; such as 'strong', 'satisfactory', or 'weak', where 'strong' earns the most attractive risk weight, 'satisfactory' attracts a smaller but recognized lower risk weight, and 'weak' is assigned a risk weight equal to that of an unsecured exposure. Assessment of important factors of the collateral package should be required in a similar manner as the collateral package assessment of specialized lending categories in Basel II, Annex 6. In keeping with the objectives of the Committee, a smaller number of categories with some objective criteria and a fixed risk weight for each category would reduce risk weight variability and appropriately increase risk sensitivity. In addition, we think adequate risk sensitivity would be achieved by differentiating risk weights for specialized lending based on residual maturity of below and above one year. Specialized lending businesses are transaction orientated, and the risk toward completion (e.g. ship is built, oil has arrived in haven) is lower.

To put the lower risk of secured lending in perspective, the 25-year average recovery of senior secured bonds is approximately 15 points higher compared to bonds without security, based on published information from Moody's Investor Services. The persistent history that security is materially beneficial to lenders is not surprising. The leveraged loan market often involves loans to secured borrowers that are below investment grade. Over the past 18 years, Moody's finds that recovery rates have averaged nearly 67%, or more than 10 points higher than secured bonds. Important work has been done by others, notably Global Credit Data to collect actual bank data on recoveries, which supports the conclusion of materially higher recoveries for secured exposures.

Increase in Off-Balance Sheet Credit Conversion Factors

Significant increases in CCFs for off-balance sheet commitments under the current proposal are extraordinarily punitive. Specifically, the CCF for unconditionally cancellable commitments for retail counterparties would increase from 0% to 10%/20%, and all other unconditionally cancellable commitments would increase to a uniform yet undecided 50%/75%. Additionally, the CCF for all irrevocable commitments, regardless of maturity would also increase from 20% or 50% (depending on original maturity) to 50%/75%. Our internal estimates for CCFs on unused limits for Swiss corporates are substantially lower than 50%, even including a margin of conservatism. Based on our understanding of the Global Credit Data, the proposed level of CCFs is far too high.

There is a clear distinction in practice and legal contract wording between revocable and irrevocable loan commitments. From an economic and client point of view, a borrower would not pay a fee for a borrowing facility if the contract specifies that it is immediately cancelable. Not all such revocable facilities could be migrated to committed lines that usually pay a fee, thereby increasing the cost of these facilities to clients and limiting the flexibility to manage their business. In many countries, not only Switzerland, the large banks are the main providers of these often unsecured, revocable facilities. Smaller banks cannot be expected to compensate with a sufficient volume under the same prohibitive CCFs. The related decline in available lending capacity will restrict companies in their flexibility and create substantial inefficiencies in lending. Given the material increase in CCFs, revocable facilities will no longer be provided or if so, only at a prohibitive cost. We are concerned that the contemplated introduction of unduly high CCFs on both revocable and irrevocable commitments will lead to curbed lending.

In summary, we see a clear need for a differentiation in CCFs between revocable and irrevocable facilities. The increases in proposed CCFs will also likely have an undesirable side effect on the computation and level of the leverage ratio. We therefore propose a 0% CCFs be retained for undrawn unconditionally cancellable commitments and should not be limited to only retail counterparties, as well as keeping the 20% CCF for trade letters of credit, which is vital for global trade. Additionally, for irrevocable commitments, the CCF should be calibrated to the lower end of the 50%/75% range which is consistent with our internal and current industry data.

Real Estate Exposures

We believe that additional eligible collateral in the real estate loan-to-value (LTV) calculation should be taken into consideration. This collateral is often required from clients to reduce risk and therefore, should reduce the related risk weight. For example, if a client uses his savings to obtain a lower LTV mortgage, this results in a beneficial impact under the standardized approach as compared to a client who only pledges his savings with a higher LTV mortgage. In both cases, the risk to the bank is the same. Using savings as additional collateral for mortgages is a very significant instrument in many countries and should be reflected in the ultimate risk weight.

Buy-to-Let (BTL)

We are also particularly concerned about the difference in proposed risk weights for regular mortgages (where 'repayments are not materially dependent on cash flows generated by the property') of 25% - 55% to the possible risk weights for BTL (where 'repayments are materially dependent on cash flows generated by the property') of 70% - 120%. In some jurisdictions, core BTL lending typically involves high financial quality landlords, where the ultimate risk levels are regarded as being on par with residential mortgage lending. We suggest including conditions which, if met, would allow the use of the lower regular mortgage risk weights for high quality BTL lending.

We also agree with the comments made by the Joint Association that guidance on how the term “materially dependent” should be interpreted to ensure that any increase in risk weights is restricted to residential real estate loans that exhibit higher loss experience commensurate with the higher risk weights. The test for material dependence could, for example, be based on determining if the loan would still meet the required standard for debt service coverage with a haircut applied to rental cash flows or by meeting a general threshold with respect to the ratio of rental cash flows to total cash flows. This addresses the fact that a high level of rental income is not necessarily a problem and may in fact characterize high quality lending.

Introduction of Currency Mismatch add-on

The introduction of an add-on for currency mismatch will be operationally challenging to identify the risk, implement and record in current risk systems, and maintain a highly burdensome level of due diligence to administer a detailed audit trail on an ongoing basis:

- For retail counterparties, banks will need to analyze the borrower’s predominate source of income for all private clients. The setup of such a regulatory control framework for the currency breakdown of the income of borrower would constitute a heavy administrative burden with a very limited risk differentiation.
- For exposures secured by residential real estate, a bank could have a very large number of mortgages held in trading and available-for-sale portfolios that are held for limited timeframes prior to sale or securitization. It will be very difficult to get an accurate currency breakdown of the borrower for residential mortgages and assumptions will have to be made.
- For corporate clients, it will be difficult to assess any currency hedges in place by the borrower to hedge its foreign currency risk. The management of foreign currency risk within a corporate counterparty is already incorporated as part of the external rating and the due diligence requirements will assess any additional risk from currency mismatch of the borrower without any additional add-on requirement.

This proposal will increase the complexity of the standardized approach while the benefit is unclear. The treatment of currency risk should remain unchanged in the credit risk mitigation framework with the current haircut for currency mismatch of 8%, when the exposure and collateral are denominated in different currencies.

Capital Floors

We understand the Committee contemplates using the revised standard approach proposal as a basis for a capital floor. We strongly believe that the new proposals coupled with a high capital floor will reduce the incentives for institutions to adopt or continue to invest in risk-sensitive internal regulatory capital models. We welcome the G20, Financial Stability Board and BCBS commitments to not significantly increase capital requirements as a result of the proposed changes to the standardized approach for credit risk.

Linkage of Rules throughout the Capital Framework

There are various direct and indirect references throughout the capital framework to the standardized approach to credit risk. These include the measurement and reporting of large exposures, assets and exposures under the liquidity rules, and exposures for the leverage ratio. However, we noticed that specific references within the off-balance sheet items rules in BCBS 347 are currently not directly linked to the leverage ratio regulations. We recommend that consistency be applied throughout the various regulations to reference a common standardized approach for credit risk. However, this would cause the need for additional recalibration if the proposed standardized approach is intended to impact the leverage ratio rules.