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Credit Suisse response to the Consultative Paper on 'Revisions to the Standardized Approach for credit risk' (BCBS 307)

Credit Suisse AG ("CS") would like to thank the Basel Committee on Banking Supervision (the Committee) for the opportunity to comment on the consultation paper 'Revisions to the Standardized Approach for credit risk' (BCBS 307). 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, 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 questions asked in the consultation paper in the Appendix to this letter.

- **Overall increase in capital requirements** – The proposed changes indicate significant increases in capital requirements through increased risk weights for certain exposure classes. For example, the lowest risk weight for bank exposures would increase from 20% to 30%, while that for corporate exposures would increase from 20% to 60%, without any benefit for secured exposures. In addition, the credit conversion factor (CCF) for unconditionally cancellable commitments would increase from 0% to 10%, and the CCF for other commitments, regardless of maturity would increase from 20% or 50% (depending on the maturity) to a uniform 75%. Additionally, the Committee plans to use these proposals as a basis for a capital floor which will further increase credit risk capital requirements for banks using an internal model method. We urge the Committee to reconsider the increase in capital requirements from these proposals, given banks are already subject to stricter capital requirements over the coming years through the regulatory adjustments under Basel III coming into full effect and the implementation of the Too Big to Fail principles for global systemically important banks (G-SIBs). We also strongly believe that the new proposals coupled with the capital floor will reduce the incentives for institutions to adopt or continue to invest in risk-sensitive internal regulatory capital models.
- **Reducing reliance on external credit ratings** – We strongly believe that external credit ratings are an important source of information that take into account various aspects of the financial strength of a counterparty, including the counterparty's liquidity, leverage, income, portfolio performance statistics and other relevant qualitative and quantitative data, as well as differences across jurisdictions and industries. Specifically, during the financial crisis, liquidity was a major factor in failures in the financial sector, which is not taken into account in the proposed rules. The risk drivers selected by the Committee are procyclical. An important strength of external credit ratings is that they are through-the-cycle measures

of risk. We are also concerned about the lack of availability and comparability of the proposed risk drivers across various jurisdictions. External credit ratings are calculated consistently and are available on a universal basis. For these reasons, and those highlighted in the Joint Association's response, we support the continued used of external ratings in the revised standardized approach to credit risk.

- **Credit Mitigation using Credit Derivatives** – Under the proposed approach, credit derivatives that do not specifically identify "restructuring" as a credit event will no longer be an acceptable credit mitigation technique. Currently under Basel II, these credit derivatives give partial mitigation albeit capped at 60%. We believe the elimination of these credit derivatives creates a hardship to banks in the US, where standard credit derivative documentation does not include "restructuring" as a credit event, since restructurings are included within Chapter 11 of US bankruptcy laws. Therefore, a specifically identified credit event for restructuring is superfluous. The final rules should not exclude these credit derivatives in their entirety, but should address the inconsistency in the use of the term "restructuring" across jurisdictions.
- **Availability of Detailed Information** – BCBS 307 proposes various alternative risk drivers to external credit ratings that we believe may not be readily available in the financial systems of many banks for use in regulatory calculations. Additionally, certain risk drivers are not available from institutions in various jurisdictions who have not adopted the BCBS capital framework. Given the significant technology investments and implementation efforts that will result from the proposed changes, we urge the committee to consider a transitional period for the application of the new rules in order to compensate for the high risk weights (e.g., 300%) that would apply where these risk drivers are not readily available.
- **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 the leverage ratio. However, we noticed that specific references within the off-balance sheet items rules in BCBS 307 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.

The changes proposed in BCBS 307 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 the proper calibration of the approach in combination with any proposals for capital floors has been performed. This will allow the Committee to fully understand the overall impact of the proposed rules and help to ensure the final rules fulfill the Committee's intended result.

Yours sincerely,

Charlotte Jones	**Stephen Haratunian**
Managing Director	Managing Director
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APPENDIX - Detailed CS comments on questions

Question 1 – 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?

As per our concerns highlighted in the main letter on reducing the reliance on external ratings, we do not consider it adequate to solely use capital (and asset quality ratios) to determine risk weights and hence, urge the Committee to continue to use external credit ratings in its new proposals on SA for credit risk.

The calculation of either the CET1 or Tier 1 ratio continues to evolve with the revised framework. For example, the use of a standard approach floor will increase RWA across many banks, but not a simultaneous change in the creditworthiness of the bank. To maintain a consistent calibration based on the actual credit worthiness of counterparties, the standard approach will need to be adjusted each time the calculation of RWA is revised. However, with respect to the proposals on the selection of a capital adequacy ratio, we prefer the Tier 1 ratio as the CET1 ratio is subject to more national discretions (e.g. differences in the adoption of transitional provisions for deductions from CET1). We do not believe it is reasonable to compare the leverage ratio to capital ratios, as the former does not take any risk considerations into account.

Calculations in line with Basel III would be ideal as it creates a comparable basis across different banks and we prefer that calculations are taken from audited accounts in order to ensure credibility of the risk drivers. For banks not having audited information, we suggest the continued use of external credit ratings.

Question 2 – 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?

Generally, net NPA ratio is not a good indicator of credit risk as asset quality ratios can vary between countries in terms of how stringent the definitions are. For example, banks in countries which have extended regulatory forbearance may show acceptable asset quality ratios, which would attract a lower RWA than an otherwise rating implied RWA amount. Additionally, our experience has shown that there can be jurisdictional differences in NPA ratios, capital ratios, classification of rules as non-performing and the term impairment.

We would recommend using the gross NPA, i.e., before deductions of reserves, as net NPA can be calculated in many variations. We also prefer to use (Equity + Loan Loss Reserves) / (NPA + Restructured Loans + Foreclosed assets) to determine adequacy of economic resources to cover potential losses.

Question 3 – Do respondents have views on the proposed treatment for short-term interbank claims?

As highlighted in our response to Question 1 and the main letter, we do not consider it adequate to solely use capital and asset quality ratios, versus external ratings, to determine risk weights, and hence would not recommend only using these for reduction in risk weights for short-term interbank claims. We believe liquidity and/or access to short-term funding, which are generally taken into account in external credit ratings, are important when considering the capacity to repay short-term debt.

Additionally, in qualifying for the preferential risk weight treatment, the "expectation" factor, as currently suggested in the Committees proposals in Annex 1 paragraph 18 of BCBS 307, could become subjective. We suggest it be modified such that any roll-over would immediately disqualify the preferential treatment for the current period as well as retroactively the immediately preceding period when such interbank placements were made.

We also suggest that the proposals be amended to look at the remaining life of the claim, rather than the original maturity, to determine short-term claims.

Question 4 – 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?

Ignoring the external rating of a bank and the sovereign cap rating factor, which is present in the current standardized approach to credit risk under Basel II, the proposed approach in BCBS 307 is likely to understate the riskiness of bank exposures in developing countries. The sovereign rating would normally capture risks reflecting a jurisdiction's competence and effectiveness in respect of its legal system, regulatory framework, corporate governance and institutional infrastructure, which would be omitted if we only refer to a bank's CET1, Tier1, Leverage or NPA ratios to determine the applicable risk weight. In addition, we agree that country risk should be considered, however not necessarily country of incorporation, but the country where the bulk of assets and/or risks reside.

We also believe that exposure to regulated entities warrant a preferential treatment due to the supervision of these entities compared to completely unregulated entities. Hence, one might consider extensions of preferential treatment to, for example, regulated insurance companies.

The continued use of public ratings would provide the best solution to the problem of the usage or non-usage of Basel III. However, we can also offer the Committee a few other options for consideration for exposures to banks not subject to Basel III. One option is for the Committee to address this issue through the creation of a class of higher risk weights applicable to such banks to reflect the potentially higher risks in association with the non-compliant jurisdiction. A second option would be for exposures to banks not subject to Basel III to either (i) have an add-on capital requirement applied to exposures; or (ii) use the risk drivers of revenue or leverage as suggested for the corporate asset class in BCBS 307. We also ask the committee to continue to encourage non-Basel III compliant jurisdictions to adopt Basel III.

Question 5 – 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?

As with bank exposures, we believe that external credit ratings are a better common factor for determining RWA for corporate exposures, as they will take into consideration various other factors that are not considered in the current proposals. These include factors such as legal and regulatory risks specific to the jurisdiction of the counterparty, factors specific to the industry of the counterparty, for example, utilities or service companies vs. manufacturing companies, growth rates and margins. We believe the corporate universe is very heterogeneous and cannot be measured adequately with only two risk measures. Rating assessments are much more comprehensive, sensitive to the aspects and drivers of specific industries and market environments with both a backward and forward looking view.

We also believe that revenues are very one-sided and in general are not very robust, and a factor like EBITDA would be a better risk measure. However, it should be noted that EBITDA is also very dependent on accounting standards.

We consider the proposed leverage differentiation from 1-5 as small. The simplified approach to leverage does not accurately reflect the nuances of specific businesses, including technology and service companies that may have relatively lower assets, whereas, hedge funds typically fall into the corporate exposure class and can have leverage greater than 5. Additionally, the specific type of assets included on the counterparty's balance sheet, such as goodwill, may skew the results of a simplified leverage ratio calculation, which is based on the accounting standards of relevant jurisdictions.

We also consider the risk scaling to be too small, since the corporate asset class covers a broad range of counterparty types including manufacturing, utilities and non-bank financial institutions (for example hedge funds, broker/dealers).

We agree that off-balance exposures should be included, but with some appropriate scaling factor aligned conceptually to IRB.

Question 6 – 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?

We consider a 110% risk weighting for start-ups as overly beneficial. We have no opinion on SME, and respectively no beneficial treatment for SME under the proposed approach seems to be necessary for us. We also urge the Committee to align the treatment of SMEs with IRB.

Question 7 – Do respondents think that the risk sensitivity of the proposal can be further increased without introducing excessive complexity?

As per our response to Question 5, the corporate asset class should be split up into more granular asset classes. Examples include manufacturing, non-financial services corporate, financial services corporates, as well as a differentiation of secured versus unsecured corporate exposures. The range of risk weights should also be expanded to match the respective asset classes, with specific benefit for secured exposures.

Question 8 – Do respondents agree that introducing the specialised lending category enhances the risk sensitivity of the standardized approach and its alignment with IRB?

We strongly agree with the introduction of the specialized lending category in the revised standardized approach and suggest that there is alignment with the IRB approach. One option for this alignment could be by using the same RWA formulas as under IRB and the proposed standardized approach, with predefined PD, LGD and maturity values in the standardized approach. Another option could be to introduce a slotting framework for the standardized approach analogous to the slotting framework currently applied under IRB. Per the slotting approach, the bulk of loans are at least "satisfactory" and receive at most a 115% risk weight, whereas few loans would be classified as "weak" or a 250% risk weight. We see the proposed treatment as insufficiently risk sensitive and may encourage investments in lower-quality loans, which are risk-weighted the same as higher-quality loans.

Question 9 – 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?

In general, for non-real estate retail, the most relevant risk driver is delinquency. Other counterparty related risk drivers such as debt service coverage, debt-to-income ratio, the length of relationship or figures related to the wealth of the counterparty (e.g. assets under management relative to debt), can also be considered as suitable risk drivers to assess risk of retail exposures.

Question 10 – 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 agree LTV and DSC ratios have sufficient predictive power. However, there needs to be a very clear definition of how LTV and DSC are calculated in order to make them comparable. There is also a need to account for national specifications in the calculation of these risk drivers such as the use of amortization, accounting for additional (financial) collateral, the use of net LTV versus a pure gross LTV taking into account only property value and loan.

For the DSC ratio, we urge the Committee to clarify whether taxes, social deductions, other costs of living, income from capital (or capital consumption) or other sources are considered, and if so, how these are considered. Ideally, this should be left to national supervisors to account for specific national circumstances. However, we consider these differences will make measures comparable at a global level and should be taken into consideration by the Committee in its new proposals.

Question 11 – 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.)

As per our response to question 10, we agree to the measurement and to keep it constant.

Question 12 – 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?

A clear definition of DSC globally is probably challenging. Fixed thresholds always pose the issue of cliff effects. If possible, a continuous function or calculation should be present.

Question 13 – 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?

Paragraph 39 states that non-qualifying residential real estate loans should be considered unsecured, which is essentially creating a new class of hypothetical assets. Lenders would not typically grant a large unsecured loan to an individual customer, and would only do so if secured by real estate. Additionally, in many developed markets, residential mortgage loans are non-recourse, whereby risk-weighting them as full-recourse appears overly conservative. Therefore, risk-weighting should never exceed 100%, i.e., treated as a retail exposure, and not be treated as a corporate exposure, as suggested in BCBS 307 proposals.

Paragraph 41 also suggests using data from credit bureaus and credit reference agencies. In certain developed markets, consumer credit ratings are available, which are based on far more attributes than LTV and DSC. We suggest including additional guidance or a mapping of consumer credit ratings to appropriate risk weights, which would reflect a simple, risk-sensitive and unbiased approach.

Separation of owner occupied versus buy-to-let and a private counterparty versus a corporate counterparty category could increase risk sensitivity without increased complexity.

Question 14 – 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 believe that opting for only option A would give the wrong incentives, because having real estate as collateral is always better than being unsecured. Our preference would be to allow for the better of the two approaches proposed by the Committee, so that the risk mitigating effect of real estate collateral can be taken into account where it is present, and the quality of the counterparty can be taken into account where collateral is not present or is inadequate.

Question 15 – What other options might prudently increase the risk sensitivity of the commercial real estate treatment without unduly increasing complexity?

Introducing a further differentiation in types of real estate types (for example, office and industrial) that can be easily re-purposed can potentially increase the risk sensitivity of CRE treatment.

Question 16 – 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, we agree. To apply this to exposures other than owner-occupied residential real estate would pose probably an undue operational issue.

Question 17 – Do respondents consider the categories for which a CCF is applied under the standardized approach to be adequately defined?

A change in the standardized approach for credit risk related to off-balance sheet exposures will have a direct impact on other regulations, including measuring and reporting large exposures, liquidity rules, and potentially the leverage ratio.

For traditional off-balance sheet commitments held in a banking book, the supervisory framework for measuring and controlling large exposures specifically references the standardized approach for credit risk to create credit exposure equivalents through the use of the credit conversion factors ("CCF")s. However, for the purpose of determining the exposure amount of off-balance sheet items for the leverage ratio, the CCFs are set out in an annex to those rules, which currently correspond to the Basel II framework, but are not directly linked to the standardized approach. This would cause the need for additional recalibration if the proposed standardized approach is intended to impact the leverage ratio rules.

Additionally, without specific reference the standardized approach in the leverage ratio rules, the off-balance sheet CCFs under leverage versus the new SA to credit risk will be inconsistent. The standardized approach to credit risk is also referenced in regulations for liquidity, and the new proposals could have a significant impact to liquidity ratios, including levels of HQLA for LCR and required stable funding factors applied to exposures under NSFR.

We recommend that consistency be applied to the rules throughout the various regulations to reference a common standardized approach for credit risk, taking into account the impact of the revised rules.

We also ask the Committee to consider differentiating underwriting facilities further between those that are accepted and unaccepted.

Question 18 – 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.

We do not agree with a steep increase in CCF to a flat rate of 75% for all irrevocable commitments regardless of maturity. The current tiered approach based on contractual maturity is more in line with actual probability of drawdowns under these facilities. Many borrowers enjoy economical "as needed" funding through committed facilities and the proposed treatment will result in higher costs passed on to borrowers. Our experience of drawdowns under these facilities has been in line with the current CCFs of 20% and 50%. Similarly, we do not feel the increase in CCF for unconditionally cancellable commitments from 0% to 10% is in line with actual experience. The difference between uncommitted facilities and unconditionally cancellable facilities appears negligible, and any risk weight greater than 0% for an uncommitted facility seems inappropriate.

We also perceive this proposal to be one of extreme conservatism. CCF is indeed difficult to quantify on a line-by-line basis and is easier when considering portfolios of assets as the behaviour can be analysed with more confidence. There is evidence from the credit crisis bailout period, which has been the most severe liquidity crisis in living memory, that the CCF of commitments to corporate exposures did not exceed 50% on a diversified portfolio basis.

Question 19 – What are respondents' views on the alternative treatments currently envisaged for past-due loans?

We believe that provisioning based on an internal credit analysis through CET1 capital should be adequate to cover expected losses. The exposure at default of a past due loan should be net of any provisions and writeoffs and then risk-weighted at a flat 100%.

Question 20 – Do respondents agree with the proposed treatment for MDBs?

We agree with the proposed treatment but also ask the committee to align the approach for MDBs with the IRB approach, allowing for a 0% risk weight under IRB. The Committee may wish to consider that in reality, corporates are generally not similar to MDBs in their credit profile and MDBs are generally more similar to development banks in their credit profile. The alternative way to think of MDBs is that they bear credit characteristics of a broker/dealer in funding profile, but with very long-dated assets.

Question 21 – What exposures would be classified under "Other assets"? Is a 100% risk weight appropriate? (Please provide evidence where possible).

We do not foresee any additional clarifications necessary in the other assets category. We agree with a catch-all category of "other assets" for those exposures that cannot be easily covered in the previously mentioned exposure categories, and agree with the risk weighting of 100% for these exposures.

Question 22 – What are respondents' views on the above alternative ways to define eligible financial collateral?

We agree with the Committee's proposals on alternative criteria to external ratings for jurisdictions and types of collateral that currently cannot use external ratings. However, we support this approach in conjunction with a continued use of external ratings, where available, for the universe of eligible financial collateral.

Question 23 – 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?

Although it is not the objective of the Committee to increase overall capital requirements, the increase in haircuts across the different collateral types and maturities suggest otherwise. In our view, to base the differentiation on risk weights looks like a consistent approach within the framework. However, this is very dependent on an appropriate way to assign the risk weights in the first place. This approach also increases the 'model risk' that is embedded in new proposals. Assigning risk weights on the collateral side will require additional effort for processes, data sourcing and calculations for banks. This is also likely to be much higher than on the exposure side, since number of eligible collateral issuers in scope can be much larger than credit counterparties.

Question 24 – What are respondents' views on the proposed corporate guarantor eligibility criteria?

Many banks purchase first-loss protection on pools of assets via synthetic transactions, whereby counterparties outside of those listed in paragraph 130 are a key outlet for these transactions. Providing no RWA relief for purchased protection with these counterparties will discourage hedging and reduce liquidity. The provision of substantial initial margin on a protection transaction might be a good threshold for non-bank guarantors. Excluding non-bank guarantors would seem to reduce the ability of banks to distribute credit risk outside the financial system, but it's not clear if that is the intention of the Committee, and if so, why.

We also believe the definition lacks clarity (especially bullet points b) and c)). We assume the definition is supposed to give comfort that the guarantor is willing and able to perform under the guarantee. Therefore, the requirement should state exactly that.

As mentioned in the cover letter, we highlighted that there is an inconsistency in the use of "restructuring" in CDS contracts due to differences in bankruptcy laws of various jurisdictions. Additionally, we would like to highlight that standard CDS indices contracts cleared through US Central Counterparties ("CCP") do not include a credit event for restructuring, whereas standard CDS indices contract cleared through European CCPs includes a standard restructuring credit event. The elimination of these credit derivatives will cause an inconsistency across jurisdictions, whereby under the same scenario a European restructuring may receive 100% credit mitigation, but would receive 0% mitigation for a US firm if restructured under US bankruptcy laws, since a specific restructuring event is not considered necessary. The final rules should not exclude these credit derivatives in their entirety, but should address the inconsistency in the use of 'restructurings' across jurisdictions.