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	BSBV 189/Dr.Egger	3137	27 March 2015

Revisions to the Standardised Approach for Credit Risk – Consultative Document

The Division Bank and Insurance of the Austrian Federal Economic Chamber, as representative of the entire Austrian banking industry, appreciates the possibility to comment on the consultative document "Revisions to the Standardised Approach for Credit Risk" and would like to submit the following position:

1. General comments

We agree on the aim to review the standardised approach for an enhanced suitability to calculate the capital requirements for credit risk exposure. We support the objectives to introduce a more risk sensitive calibration in general and to increase the comparability between banks.

The proposed review reveals a number of decisive criticalities that need to be addressed to avoid unintended and disproportionate negative impacts on credit institutions. In some cases (e.g. residential real estate collateral) we do not understand, why the current approach should be changed at all, as we can see no problem with the current situation.

We have significant concerns about the elimination of external credit ratings from the classification of credit risk exposure. The reasons for this objective are comprehensible, but replacing external credit ratings with simplified risk indicators is not appropriate in this case. External credit ratings have advantages compared to a 2-risk indicator approach as proposed in the document for bank and corporate exposures:

- Inclusion of a broad set of indicators: Firstly, using just two indicators known by the assessed party makes it easy to influence these two figures. Secondly, with reducing the assessment to two indicators additional information provided by a broad set of risk indicators is lost.

- Inclusion of quantitative and qualitative information: Qualitative information is neglected in the current proposal, whereas it is important for a sound assessment.

- Inclusion of external factors like market, sector, economy, political and environmental situation: External Factors are neglected in the current proposal, whereas these factors have a influence on the credit risk of a certain exposure.

- Consideration of different business models: Different business models have a significant effect on the credit risk, but a differentiation of business models is not mentioned in the proposal.

- Inclusion of the future outlook: The 2-risk indicator approach uses just historical data, which may differ substantially from the current and future situation.

- Consideration of recent developments: Recent internal or external developments (oil price decline, Ukraine crisis, etc.) may change the credit risk of a party significantly. External credit ratings are updated if an internal or external event with effect on the credit rating occurs, whereas in the proposed approach the outdated indicators are maintained until a new financial report is available. The time until a new financial report is available will last up to one year which is definitely too long.

- Consideration of different accounting standards: As proposed in the Consultative Document the risk indicators like revenue or leverage should be calculated according to the accounting standard the party is using. Different accounting standards will lead to different classifications of exposure.

From our point of view, the proposed 2-risk indicator approach cannot replace the external ratings, but with reasonable indicators and calibration it is an approach to improve the classification of unrated exposure.

The new standardised approach will be the benchmark for all banks in the EU, including smaller banks as it is the exclusive calculation method for the calculation of capital requirements (beside the IRB approach). Regulators should keep this in mind and thus design them not too complex in order to make it possible to implement for smaller banks.The new suggestions are highly complex and especially for smaller banks increase the difficulty to apply the calculation method (e.g. evaluation and monitoring of the different risk drivers, the generation, collection and administration of numerous data). We have serious doubts that the proposal fits these requirements. The implementation of these new rules will certainly overburden small banks (in the EU and globally). We seriously wonder, how institutions in less developed countries will be able to comply.

We are critical towards the proposal for higher risk sensitivity by the introduction of two risk-drivers. The proposed risk drivers will not give a full picture but introduce a two-dimensional approach that may deliver inappropriate results. We therefore support a more schematic approach that allows supervisory processes to monitor appropriate methods of risk assessment for smaller banks. Additionally we doubt that the SA generated on the basis of only two risk drivers should be used for a floor-calculation for banks using IRB (since the IRB disposes of a much higher risk sensitivity). Due to different accounting standards, the calculation of different risk drivers (such as leverage) may provide differing results.

Furthermore we are sceptical about the proposal for banks to collect data. The consultative document proposes an extensive introduction of data collection on customers and corporates on a frequent basis. Such data requirements will lead to disadvantages and high costs in particular for small banks.

Most importantly we would like to express our concern that the review of the SA will lead to substantially increased capital requirements. Although BCBS states that this should not be the

case and therefore is not the purpose of the revision, some exposures will be considerably increased (e.g. the lowest risk weight for bank exposures would increase from 20% to 30%, while that for corporate exposures would increase from 20% to 60%).

Moreover, it seems that the proposed revisions would mainly penalize banks with high quality portfolios (capital increase for high quality mortgage portfolios and increases for the minimum weights of banks and corporates). This could potentially result in wrong incentives for banks using the SA for credit risk and, given the intended capital floors, also the high quality IRB portfolios will be hit disproportionally.
In this regard, the overall calibration of certain requirements (e.g. corporates), may be much more burdensome for smaller banks, financing smaller business, and the joint effect of some measures (corporates, retail) may even amplify restrictions on financing.

As a matter of fact, the calibration of certain elements will have implications on the general policy of banks. These choices go far beyond risk management:

- A potential degradation of access to finance for SMEs, vs. a preferred treatment for large corporates;
- A pressure towards consolidation to achieve greater size of banks (e.g. the hardened granularity criteria for retail exposures).

In addition, we see a lack of level playing field. Other financial service providers could have an enormous advantage by not having these high capital requirements which are applicable to banks.

We therefore strongly suggest to reconsider the objective to eliminate external credit ratings from the majority of risk categories.

The aim to restrict national discretions should be reconsidered, too. Flexible ranges for some parameters enable national regulators to create a well-suited regulation for different jurisdictions. The Basel Committee should try to find appropriate ranges and calculation methods for the regulators to define their national parameters to avoid cherry-picking.

Exposures for banks active in the factoring business

It must first be pointed that in contrast to the other European countries Austrian factoring institutions are licensed banks. Therefore they are subject to the Austrian Banking Act and the Basel IV regulations.

We would like to point to a serious problem credit institutions active in factoring would face with the current proposal. As stipulated in the consultative document, exposures to certain companies and natural persons, where specific required data are not available might have to be assigned with the highest risk weight, i.e. 300%. Given that it is the very business of specialised factoring credit institutions to purchase the claims without being in a contractual relationship with the borrower, it is not possible for these institutions to receive all the required data

It is therefore of utmost importance to consider these specialised business models of factoring banks which plays an important part in the financing of the real economy and to provide reasonable exemption clauses for factoring. Otherwise the whole business model of these banks would not be profitable anymore and factoring would be seriously endangered in its existence, even though it is very important for SMEs to provide liquidity by these means.

2. Exposure to banks

The reliance on external ratings for bank exposures should be preserved. External ratings on bank exposures have not proved inadequate in the past. Newly developed regulations on bank exposures have focused on the close monitoring of risk profiles, and have been constantly improved with regards to liquidity aspects, resolution, leverage, stress impacts. We also do not see why the lowest risk weight in banking has been raised to 30 %.

We fear that problems will arise from the implementation of a rule which stipulates that the breach of any minimum prudential requirement imposed by supervisors (e.g. SREP) would trigger a 300% risk weight. (E.g. would such a treatment really be justified if a bank shows a LCR of 99% or if a bank fails to reach a pillar 2 SREP-ratio imposed at 20% own funds?)
It also has to be taken into account that the use of the proposed indicators on a yearly basis could trigger a concrete risk of pro-cyclicality that would bring no benefit in risk appreciation. The chain effects on funding costs should be properly considered in final calibration.

In case of cooperative banks, local member banks are obliged to hold deposits in a central institution and do not engage in risky trading and investments as the central institution manages the entire intra-group liquidity. Therefore lower risk weights should be applied. The recognition of these elements is particularly important especially when local banks of cooperative groups and networks have a legal obligation to maintain funding at the level of their central institution. The respective EU legislation (such as the 0% risk weight for intragroup or intra-IPS exposures) respects these specificities.

Moreover the use of the actual CET 1 ratio for the QIS study is problematic, because probably after implementation of the proposed revision of the standardised approach the CET 1 ratios of banks could further deteriorate because of higher risk weights.

In general the rise in risk weights from a range of 20 % and 150 % to a range of 30 % to 300 % will probably lead to a more restrictive use of the inter bank money market. Therefore the significant rise in risk weights for these exposure classes would likely cause negative effects in a tense economic climate.

Q.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?

Q.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?

Basically, external credit ratings should not be eliminated for classifying bank exposure. However, using the 2-risk indicators approach would be appropriate for unrated bank exposure.

The capital adequacy ratios are suitable risk indicators. The CET1 ratio and the tier 1 ratio are superior to the leverage ratio, because they are risk-sensitive, whereas the advantage of the leverage ratio is the possibility to use it for banks that are not subject to Basel III.

Regarding the strict definitions of CET1, tier 1 and tier 2 capital and the principle of loss-absorbing capacity in all categories, it seems appropriate to take the total own funds ratio instead of the CET1 or tier 1 ratios. In case of a credit event also the obligors tier 2 instruments are bearing losses before the senior ranked liabilities contained in this risk category.

We doubt the net NPA ratio is an effective risk indicator. Even though it reflects the total assets (not just specific parts of the business) and includes the accounted provisions the methodology could lead to inconsistency among banks: e.g. the criteria for recognition of impaired assets may differ country by country due to differences in supervisory approach and accounting.

The importance of the net NPA ratio is closely related to the level of interest rates in a given economy. Markets and interest rate levels differ a lot in different jurisdiction. With e.g. 10 % interest rates a NPA ratio of 4 % will be no problem for a bank, while things would be completely different with interest rates of 3,5 %. Therefore we do not believe, that the net NPA ratio is an adequate measure for distinguishing bank exposure's credit risk. It is better to rely on external ratings and – where the calculating bank decides not to choose an ECAI for this kind of exposure or where there is no rating – to refer only to the CET1 ratio.

From our point of view, the proposed calibration of risk weights for both factors (net NPA and CET1 ratio) is too high, not reflecting the real credit risk of a credit institution. Especially the 300% risk weight seems exaggerated compared to the risk factors of other classes.

The proposed rule to use the 300% weight in case the obligor bank has breached any binding minimum prudential standard required by its national supervisor is inappropriate and creates unnecessary burden for banks to monitor all national standards across different countries. It is sufficient to rely on the two proposed indicators.

Moreover it is crucial that the used parameters are part of the public regulatory reporting of pillar 3.

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

A stronger differentiation is needed between short term and long term exposures. A separation of the risk weight table of these two different kinds of exposures should be introduced (with a 1 year maturity threshold). The sensitivity of the proposal would be further increased by this suggestion.

The proposed RW table is based on the assumption of a 45% LGD and maturity of 2.5 years. However, the single risk weight table may not reflect the riskiness of a short term bank exposure in an appropriate manner, in part exactly because of the assumption of 2.5 years maturity.

The treatment proposed for short-term claims is in fact not adequate, only if they have an original maturity date of less than 3 months they may receive a 20% points lower RW than the one determined in accordance with the proposed risk drivers, but subject in any case to a risk weight floor of 30%.

Q.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?

External ratings should not be cancelled for bank exposure. Then the calculation of the risk weight for rated banks that are not subject to Basel III would not be problematic.
For unrated banks not subject to Basel III it is not necessary to calculate risk-sensitive capital ratios according to Basel III. We suggest to take a national risk-sensitive capital ratio similar to the relevant Basel III ratio and treat it like the Basel III ratio to calculate the risk weight. Then, the determined risk weight should be increased by a certain add-on (e.g. 10%). In case no national risk-sensitive capital ratios are calculated the leverage ratio could be used to calculate the risk weight.

In case the Committee plans to implement an additional country risk factor we want to emphasize the importance of simplicity.

Moreover, this measure might be counterproductive to the goal of having a liquid and working interbank market and reduce the reliance on ECB short term funding.

It will also lead to an increased capital need compared to today, which might reduce the banks capability to give loans to the "real economy".

3. Exposure to corporates

Risk Drivers
We generally have doubts regarding the selected risk drivers. The proposed treatment would entail important potential disadvantages for SMEs and banks with large SME portfolios. This cannot be jusitified by our loss experiences in the last decades and is not acceptable also from a political perspective taking into account, that in Austria or the EU as a whole SMEs are the economy's backbone (99% of businesses, 66% jobs).

We strongly oppose the idea that the absolute size of a company (which absolute revenue indicates) leads to a lower Risk Weight. This is actually "reverse proportionality" and has a negative impact for the business model of cooperative and retail oriented banks, especially in small countries, where SMEs are the norm rather than the exception.

Bank-related products are still the most relevant sources of finance for euro area SMEs. According to data from the ECB from 2014, 61% of SMEs considered bank loans as a relevant source of financing, and 53% included bank overdrafts. In this context also the importance of banking relationships for SME lending must be highlighted: very often enterprises traditionally rely on a close relationship with just one local bank able to lend even when business conditions are difficult.

Therefore, the proposal raises concerns for the likely disproportionate negative impact on own funds of smaller credit institutions with a tradition of and a focus on SME lending. In Austria there are many institutions with a longstanding practice of SME lending showing a corporate exposure portfolio composed at an estimated 70 % of companies with revenues below € 5 m. This percentage would even rise if the granularity criterion as proposed in paragraph 34 of the annex 1 had to be applied, because then a big part of the retail exposure of small banks with retail exposure portfolios much below € 500 m would have to be treated as corporate exposure.

It should be avoided that technical choices have unintended fundamental policy impacts, as raising capital pressure on the activities of small banks with strong ties with the territory by making lending more expensive could also have negative impacts in terms of economic growth and stability.

Preliminary data assessment on corporate exposures and QIS
We do not agree with the preliminary assessment of the proposal that SME exposures are generally riskier than exposures to large corporates. The data on which this assumption seems to be based may not be relevant for all jurisdictions. In addition we see the argument that locally acting banks have a better knowledge of local SMEs is not considered at all. Consequently we urge for a deeper and more thorough data collection for the design of the calibration. The supplementing QIS was not directed towards certain (smaller) banks and also does not give enough time to allow for the collection of meaningful data. The QIS does not take into account that a large proportion of the data that is required is either not available in institutions' systems, or is not readily available for aggregation and reporting purposes. Indeed, much of the data requested by the proposed approach does not form part of institutions' capital processes.

The EBA third interim report on the consistency of risk weighted assets (2013) suggested that for SMEs there would be no clear linkage between the variation in the capital requirements and the exposure size. In fact, the enterprises' size (turnover/total assets) seemed to induce lower levels of PDs but also higher levels of LGDs. In addition, it indicated that SME retail and corporate exposures under the SA represent large parts of banks' exposures in this category in the EU (20% of the EBA sample). Thus, collecting significant input from SA institutions may be crucial to calibrate this category.

Q.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?

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

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

Basically, external credit ratings should not be eliminated for classifying corporate exposure. In our opinion, the proposed treatment of corporate exposure has major disadvantages compared to external ratings. Additional to the reasons mentioned in the general comments the proposed treatment does not reflect any differences between industries or sectors. To use the same risk indicators with the same calibration for nearly all corporate exposure is not comprehensible.

The proposed treatment could be used for unrated exposure, because at the moment a flat risk factor of 100% is applied. Therefore, a differentiated calculation based on two risk factors is an improvement to the current situation and more risk-sensitive. Still, there should be a differentiation between markets and industries.

Criticism of "revenue" as a risk driver:
We have serious doubts aboutt "revenue" as a risk driver of such weight. The size of a company cannot give enough reason for the evaluation of corporate exposure. In some cases the separation power of revenue in addition to leverage is rather low. Many SME do not seek for scale merits but rather specialize in niche markets in which they can still be successful.

The implementation of the bucketing envisaged by the Committee does not seem to be practical if compared with common SME definitions that use a € 50mn revenue threshold as maximum cut-off to qualify for this category, and taking into account that most of the SME portfolio is well below such threshold.

Thus, there is a clear need for identifying alternatives for SME's and risk drivers in line with the characteristics of SME exposures and with a vast data collection from credit institutions.

Criticism of "leverage" as a risk driver
Also the use of leverage as a risk driver is a problematic choice. It is an element that is based on the business sector and differ between jurisdictions (e.g. differences in trade and production sectors, differences in the tax environment, bankruptcy regulations,..)

Small corporates (e.g. with revenues ≤ € 500k) have very low levels of own funds (8% average) and overall, the vast majority of corporate exposures (70%) have revenues below € 25mn. For such customers the own fund ratio is approximately 20%. The new requirements would thus have disproportionate impact on banks who serve these kind of customers and consequently on the corporates that suffer from difficult access to finance.

The level of leverage does not necessarily reflect the risk of a company. Most exposures to smaller corporates are highly collateralized relative to exposures to large corporates and risk mitigating factors (e.g. guarantees and other collateral) should be better reflected. Star-ups will have difficulties relying on "revenues". Such definition of risk drivers would have clear negative consequences on the real economy.

Leverage is also problematic when dealing with partnerships or non-incorporated companies. In such companies there is only a fiscal/virtual separation of the company and the patrimony of the owner. The owner's patrimony remains available as collateral for the bank, even though it may not appear on the balance sheet of the company. Thus in these partnerships and uncorporated companies, differently from companies with legal personality, the liability of the entrepreneur is not limited to the own funds actually poured in the company. This may also explain why many of the smaller companies, many being uncorporated, show lower capital ratios.

Although many smaller corporates may fall in the retail portfolio, due to a hardened granularity criterion the maximum exposure in such portfolio could be considerably lower in smaller banks, so that even SMEs would be corporates.
Finally, it seems that the proposed risk drivers may induce procyclicality, also due to cliff effects in the allocation of RW to corporates at border between buckets.

We welcome the lenient treatment of start-up companies, but the risk weight of 110% still seems rather high.

The proposed range of corporate risk weights between 60%-130%/300% is too high. Compared to the current range of 20%-150% it seems rather exaggerated.

Also, the granularity of the leverage ratio should be deeper, at the moment there is the same treatment for an equity ratio from 33% to 99%.

It is important that the access to the necessary parameters to calculate the indicators is provided. Currently, it is impossible to collect the required data for all corporations. The burden both for corporations and banks will increase significantly.

Therefore, we suggest to complement the external ratings-based approach with some alternatives for the unrated corporates rather than changing the entire system.

Corporate exposures with negative equity
Negative own funds does not necessarily mean insolvency. Negative own funds are not unusual for SMEs, in particular for general partnerships/uncorporated companies where liabilities may not be entirely covered by assets. In certain jurisdictions, private assets are available also for support of the corporate exposure. There might be very good reasons for the entrepreneur not to have very much capital in his company and even to have negative own funds.

In practice such SMEs may be reliable payers. This often is also true for small private limited companies with negative equity where the managing shareholder vouches for the company. Given the high importance of SMEs for the EU economy we highly criticize that the proposed approach gives an important advantage to listed corporates.

Moreover even if the company has negative own funds, in case its accounting is based on local-GAAP also so-called hidden reserves are to be considered, because these hidden reserves can serve as an additional security. Therefore also when calculating the leverage ratio, hidden reserves should be taken into account.

4. Specialised lending

Q.8 Do respondents agree that introducing the specialised lending category enhances the risk sensitivity of the standardised approach and its alignment with IRB?

We oppose the proposed risk-weights applicable to specialised lending, with a floor at 120% or 150% as it disregards the multiple safeguards and covenants associated with these transactions.

It would make sense to take the lower of the counterparty and the specialized lending risk weight. As the financed asset is used as collateral and/or the income from this asset is used to repay the loan the general risk weight should be 120% or 150%, but with a possibility to reduce in case the counterparty risk of the corporation is lower.

The income-producing real estate category (IPRE) includes multi-family residential buildings. We think this subtype should be separated and treated different with a lower risk weight because the risk is more comparable to exposure secured by residential real estate.
In some countries non-profit oriented residential construction companies offer affordable housing units to individuals for rent and/or sale. These corporations are publicly supported with subsidies, guarantees or provided land. According to the proposal the exposure to these corporations will be treated as IPRE because the loan is repaid through income from rent or sale of housing units. We think exposure to non-profit oriented residential construction corporations should receive a preferred treatment regarding the social element of their business.

For example, in Austria even the 35% risk weight is too high and does not reflect the real credit risk of non-profit oriented residential construction companies. The real default rates over the past years are nearly 0%. A risk weight of 120% would therefore be absolutely inappropriate.

We suggest to create a subtype for multifamily residential construction companies with a low basic risk weight (maybe with a differentiation based on the LTV) and to enable national authorities to charge an add-on in case the risk of these corporations is higher in their

jurisdiction. The add-on should be based on the national default and loss ratios. Such an approach will enhance the suitability and risk sensitivity of the standardized approach.

The specialised lending (SL) transactions defined in the proposal are based on valuable assets, cash flows, ring-fenced structures. However, the proposed rules do not take into account SL strong inherent mitigants (e.g. securities on valuable asset, on tangible cash flows, ring-fenced structure).

In case the proposed RWs (120%, 300%) will be applied, we fear that a dramatic increase in margins will be the effect and will trigger the expansion of non-regulated financing, shadow banking and hamper financial stability. The introduction could force banks to finance projects and assets on a corporate base (unsecured) rather than SL based in order to reduce the costs in terms of capital.

5. Retail portfolio

We reject the introduction of a binding quantitative granularity criterion set at 0,2% of the overall regulatory retail portfolio. For institutions with small portfolios the proposed thresholds can be reached very easily. Therefore, small business-retail customers of smaller banks would be strongly discriminated. This is especially true for the Austrian situation, where we have more than 500 small locally active banks with retail portfolios often far below € 500 mn.

Moreover, the interference of both the corporate risk drivers and the strict retail criterion could lead to very important cliff effects: once an exposure to a small company falls out of the retail portfolio with 75% risk weight, it may qualify for a 130% risk weight as a corporate exposure: due to the fact that the leverage of the smallest companies tends to be rather low, such effects would probably be very frequent.

This can entail significant drawbacks: the specific business model of small banks – informally-intensive and traditional lending activity (so called relationship lending) – might be negatively affected by regulation.

Eliminating any national discretion for the granularity criterion is not useful and does not strike the right balance among the objectives of the level playing field, financial stability and bio-diversity of financial and non-financial sectors.

We strongly urge that the granularity criterion should be maintained as a qualitative requirement and national discretion should be allowed to detail it. Otherwise, a granularity threshold of at least 2% would be needed.

As for the threshold value of individual exposures, we believe that it should be raised to 1,5 million (this level was determined before 2003) and adjusted to inflation on a regular basis.

Q.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?

Where a simplified approach has been developed for smaller and less complex institutions any "cliff effects" should be a
exposure from the regulatory retail portfolio to the corporate portfolio.

In order to prevent a significant cliff effect we believe that the current treatment to non-retail small business exposures should be maintained or at least a 100% risk weight should continue to be applied for sole proprietorships/self-employment/micro businesses and for SMEs that do not meet the loan size criterion.

The preferential treatment of 75% right weight is fully justified. Therefore we do not see any reason to increase it or use other risk drivers to differentiate the risk of retail exposures which can result in an increasing of the risk weight.

As regards specific products that have different risk characteristics, compared to the other retail exposures we would like to mention the specific supervisory treatment for Salary Secured Loans and Pension Secured Loans. This technical form of consumer credit is supported by a series of guarantees that reduce the credit risk in comparison with other forms of retail loans. Salary Secured Loans and Pension Secured Loans clearly have numerous characteristics that mitigate risk: accordingly, a favorable prudential treatment (risk weight lower than 75%) should be applied.

Further and deepened analyses should be carried out in order to ascertain if it can be considered as a risk driver (or in combination with others) to better differentiate the risk of retail exposures and hence to apply a risk weight lower than 75% to exposures with characteristics such as established relationships (e.g. taking influence on the counterparts in order to prevent or manage their crisis).

6. Exposures secured by residential real estate

Q.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?

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

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

Q.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?

We do not see reason for the modification of the risk-weights for these exposures. In the EU there has been no evidence of risk appreciation problems with the current SA for credit risk. If problems occurred the competent authorities would be entitled to set higher risk weights based on the loss experience of exposures secured by immovable property and forward-looking immovable property markets developments.

In particular, the approach does not take into consideration any insurances that ensure the repayment of the loan, e.g. in case of sickness or death of the lender. In some countries there are even state programs that provide insurance against unemployment.

The proposed risk drivers have only limited predictive power for probability of default. For instance payment in arrears and utilization of consumer credit have a better predictive power. It has to be noted that there is no fixed (linear) relation between LTV and loss given default and the DSC at origination provides limited information regarding credit losses. Moreover, retaining valuation and DSC at origination is flawed as it discriminates against lenders who retain their customers and also their customers whose risk profile diminishes over time.

The use of LTV and DSC at origination (only) is not in line with good risk management, and their use to label a loan at origination as high risk for its lifetime is counter-intuitive, as it ignores the well established phenomenon of "seasoning".

Moreover, the use of LTV and DSC at origination (only) discourages prudent longer-term lending relationships. It rather creates incentives for lenders to switch to other banks or to cancel and originate a new loan with the current bank in order to draw advantage from a better LTV or DSC after some years, when the outstanding debt is reduced due to repayments, when the income has increased due to indexation and when the value of the property has increased. To introduce the DSC as one of two criteria for calculating risk weights might even be counterproductive, because it gives incentives for rather low debt services and thus slows down the speed of debt reduction.

In general the DSC is only a very “rough” indicator. It does not adequately reflect the differences in the case of a person with a high income (and patrimony) compared to a person with a low income. Moreover, ensuring consistent DSC calculations is difficult due to the variety of source of incomes. Tax is hardly a simple calculation just based on income.
A more powerful predictor to be considered could be for instance the past credit history of the borrower. As possible alternatives a differentiation of the housing market, e.g. stable/less stable/more stable (based on better loss predictive information) could be considered. In the end, a 35% risk weighted could even be better than the unbalanced, and limited risk drivers proposed as factors for probability of default. This would have the advantage to avoid a too complex revised standardised method for smaller and simpler lenders.

The proposals also disregard additional collateral/guarantees received for exposures secured by real estate. In fact, banks may grant higher LTV loans given other mitigating factors (mutual insurance, parent guarantees, mandatory building of savings, sovereign guarantees, financial collateral). If a risk sensitive approach is to be designed, one should take into account also the sustainability of house prices, with sustainable increases to be reflected in the risk weight determination.

We would also like to point out a necessary differentiation between real estate and self-builts. Self-built residential properties are specifically regulated in certain legislations (e.g. triggering tranche payment only on completion of a specific building phase) and should be adequately addressed.

Finally it could be contradictory if a loan to a private person without any security has to be risk weighted with 75 percent, whereas a privat loan secured by residential property where the LTV ratio is higher than 100 percent, will be “punished” with a 100 percent risk weight. In this case it would be inconsistent, that a loan with an allowable security will be charged with a higher risk weight than an unsecured loan.

Requirement of consideration of banking business subject to a specific legal treatment

Building societies are specialized in low risk mortgage loans according to their business model which is additionally regulated by specific national laws. Before a building society loan is granted, a customer has to save a certain amount on a deposit account. The amount of the loan relies on the paid-in balance on this deposit. This system has two main advantages regarding the credit risk. First, the building society has already an established relationship with the borrower and second the borrower has a certain amount of own means to finance the purchase of the property or the construction. These two factors ensure a better insight in the customer's situation and cause the lower risk of building society loans, which is proven by the traditional low default rates. Therefore, a preferred treatment with lower risk weights for building societies should be implemented to enhance the suitability and risk sensitivity of the standardized approach.

7. Exposures secured by commercial real estate

Q.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?

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

We believe that the proposals for commercial RE exposures are strongly influenced by bad experiences recorded in certain countries in recent years, although other jurisdictions have not undergone the same difficulties. Thus the approaches envisaged do not reflect and are too pessimistic about loss rates experienced with commercial real estate collaterals.
In general, we therefore appreciate the flexibility provided under the proposed Option A, although some of the criteria described in footnote 59 to allow a preferential treatment are still too strict.

For example Option A requires that "the risk of loan repayment must not be materially dependent upon the performance of, or income generated by, the property securing the mortgage, but rather on the underlying capacity of the borrower to repay the debt from other sources".

We believe that there is a need for a possibility to derogate from such rule, where a well-developed and long-established commercial immovable property market is present in the affected territory, and with loss rates which do not exceed certain limits (e.g. see Art. 126(3) CRR1). These very low loss rates therefore must be an alternative requirement and not (as put in footnote 59 continuing on page 38) as an cumulative requirement.
Moreover, the indirectly imposed finished property requirement may be counterproductive as real estate being a non-essential business asset often is vacant while serving best for credit risk management purposes; the requirement may also cause problems with forest or agricultural land.

With regard to Option B, we see that it is overall not sufficiently flexible. Moreover, it is unclear why the RW for commercial real estate could lead to higher RW than for similar exposures in different categories (e.g. when the exposure could otherwise be treated as

[1] "*a) losses stemming from lending collateralised by commercial immovable property up to 50% of the market value or 60% of the mortgage lending value, unless otherwise determined […] do not exceed 0.3% of the outstanding loans collateralised by commercial immovable property;*
b) overall losses stemming from lending collateralised by commercial immovable property do not exceed 0.5% of the outstanding loans collateralised by commercial immovable property."

Retail exposure or as a corporate exposure with low leverage). This does not seem to be in line with para 63.

8. Risk weight add-on for exposures with currency mismatch

Q.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?

In our opinion an additional risk weight add-on for currency mismatches should not be implemented.

First, a simple add-on would not reflect the differences between currencies and their volatility relative to each other. If the foreign currency of the loan has a close link to the currency of the customer's income it is not justifiable to charge an add-on. For two currencies facing a high volatility an add-on may be justifiable, whereas it would be operational burdensome for banks to maintain the parameters.

As an example we want to mention the situation in Croatia. Croatian banks and insurances offer products with EURO-linked clauses. The denomination currency is EURO, whereas the income of the customer is in Croatian Kuna. Thus, there is a mismatch of the exposures currency with the currency of the customer's income.

The country is part of the EU and their economy is closely interdependent with the economies of other EU countries, especially with countries in the EURO-zone. Croatia does not have introduced the EURO yet, but their local currency is closely linked to the EURO and the national authorities have a strong interest to keep the exchange rates stable. Moreover, the Croatian government issues bonds denominated in EUR. As a consequence the volatility of the exchange rate EURO and Croatian Kuna is very low.

Therefore, in this case a risk weight add-on is not justifiable.

Second, the currency of the customer's income may change over the maturity of the loan. Banks would have to check on the sources of income of their customers on a regular basis. In contrast to the principle of simplicity, this is another unnecessary burden for banks and customers.

9. Off-balance sheet exposures

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

Q.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.

In our opinion, the current CCFs and categories of standardized approach are sufficient.

10. Past-due loans

Q.19 What are respondents' view on the alternative treatments currently envisaged for past-due loans?

An alternative treatment of past-due loans should consider risk sensitivity, simplicity and include the level of provisioning.

We prefer a treatment with an add-on (e.g. 50%) on the applicable risk weight, because in our opinion this option guarantees a more suitable classification than a flat risk weight.
We also think that the recovery rate should be added as a classification indicator. Recovery rates differ significantly between exposure classes and business models and will improve the risk sensitivity of the approach. Based on our own data we know that recovery rates for loans secured by residential real estate are higher than for other loans.

11. Exposure to multilateral development banks

Q. 20 Do respondents agree with the proposed treatment for MDBs?

We do not agree with the proposed treatment like corporate exposure. The corporate class is not suitable for MDBs. We think the current treatment should be maintained.

12. Other assets

Q. 21 Do respondents agree with the proposed treatment for MDBs? What exposures would be classified under "Other assets"? Is a 100% risk weight appropriate? (Please provide evidence where possible).

No comment.

13. Eligible financial collateral

Q. 22 What are respondents' view on the above alternative ways to define eligible financial collateral?

In general, the external rating should not be eliminated from the regulation regarding eligible financial collateral. In case the external rating is eliminated, the concept of "investment grade" could be a reasonable substitution, but it is important to keep the definition of "investment grade" simple.

Q. 22 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?

No comment.

14. Eligible credit protection providers

Q. 24 What are respondents' views on the proposed corporate guarantor eligibility criteria?

The external rating as basis for eligibility of corporate guarantors should be maintained.

Please give our concerns due consideration.

Yours sincerely,

Dr. Franz Rudorfer
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