



11 March 2016

Mr. William Coen
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
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Dear Mr Coen,

Deutsche Bank is grateful for the opportunity to comment on the Basel Committee on Banking Supervision's (BCBS) second consultative document on revisions to the Standardised Approach for Credit Risk (SACR). Our response should also be read in conjunction with the letters submitted by the Institute of International Finance, and The Clearing House, which we contributed to and strongly support. Deutsche Bank will be applying both the ECRA and SCRA across our global entities as we have significant presence in the US where external ratings cannot be used.

As per our previous comments on the subject, an iterative process combining consultations and Quantitative Impact Studies (QIS) is essential for such a complex and impactful regulatory change. We are appreciative of the approach that the BCBS has taken in this regard – only through continual cooperation can we ensure that the revised SACR, especially when combined with the upcoming Capital Floors consultation, provides a useful addition to the regulatory tool-box.

However, that the actual impact and hence optimal calibration of the SACR cannot be understood until the proposal on capital floors is developed and calibrated. It is vitally important that these two, in addition to the standardised elements of the Fundamental Review of the Trading Book and any future operational risk standardised model, are carefully designed and considered together.

There are risks to calibrating the standardised approaches and floors such that an overly-simple, non-risk sensitive metric becomes the primary binding prudential regulation. Simple tools are important, but come at a cost. Caution must be taken in how they are designed and how they impact risk management, business models and financial stability. Overemphasis on simple, non-risk sensitive tools could not only result in a homogenous banking sector, but one where actual balance sheet risk is not properly risk weighted. Risk insensitive tools such as standardised approaches and capital floors camouflage the specific risk profiles as well as the riskiness of the portfolios to which they are applied. We have already seen the leverage ratio becoming a binding constraint for many banks, causing a shift from balance sheet allocation



based on return on equity, to return on assets. This incentivises banks to shift their balance sheet asset mix towards higher yielding, and potentially more risky and/or less liquid assets. This would be exacerbated by the proposed capital floors.

That said, Deutsche Bank believe that the BCBS approach of getting the SACR to a near-final stage before proposing a capital floor is the correct approach. Once the impacts of the SACR are clearer, the capital floor can be set at a level to provide a back-stop to work alongside the leverage ratio rather than a binding tool. Indeed our comments in response to this consultation should be seen as preliminary and subject to change once the holistic view of the SACR in conjunction with the capital floors is clearer.

In our response to the initial consultation, we highlighted the importance of reinstating the use of external ratings. We are grateful for the BCBS for having done this, where permitted by Member jurisdictions.

This goes a long way to increasing both the sensitivity and simplicity of the SACR. There are however areas of the revised SACR that we feel can be improved by increasing granularity. In the annex to this cover letter we discuss these in greater detail, but we would like to highlight the key issues:

- The increased Credit Conversion Factors (CCFs) for off-balance sheet items fail to reflect historical data on drawing behaviour and are overly conservative. These should be revisited based on updated information so as not to unfairly penalise trade financing and infrastructure investments.
- When considering exposures such as Commercial Real Estate (CRE), and specialised lending we propose ways to further align the capital allocated to the risk of such lending.
- There are additional issues around the use of using Loan-To-Value (LTV) at origination rather than the latest available LTV. This creates an unneeded disconnect between risk management and capital calculations.
- The mortgage valuation approach should be limited to a prudent assessment, and not look at haircuts for stressed scenarios. This creates significant complexity and is better dealt with under pillar 2 combined with stress-testing.
- We believe that the objective of eliminating the feedback loop between banks and sovereigns makes sense. However eliminating a sovereign-strength factor from bank ratings should only be mandated once such ratings are available in the market in a consistent and reliable form.
- The committee should consider increasing the recognition of diversification benefits. These can be simple to capture in the framework across numerous exposure types. The BCBS found sensible ways to include diversification benefits and materially improve the FRTB framework. Ensuring the right level of granularity, where it can be



introduced using simple additional bucketing, also ensure that prudent lending is recognised and incentivised.

In case of any questions, please do not hesitate to contact me.

Yours sincerely,

A handwritten signature in dark ink, appearing to read "Daniel Trinder".

Daniel Trinder
Global Head of Regulatory Policy
Deutsche Bank



ANNEX:

Off-Balance Sheet (OBS) Exposures –CCF

We consider the proposed Credit Conversion Factors (CCFs) too high, in particular with regards to the proposed range of 50-75% for Commitments (except retail unconditionally cancellable lines). Excluding non-retail commitments that are unconditionally cancellable from the preferential treatment as applied for retail related ones does not seem justified. The introduction of the proposed CCFs will negatively impact the working capital funding of corporates. As the BCBS proposal does not reflect historical data on drawing behaviour around the use and loss levels associated with such credit lines, we have significant concerns that this proposed treatment will impede banks' abilities to provide funding and meet client demand in areas such as, trade finance, corporate working capital needs and project finance. It should be noted that this runs directly counter to the intention of policy makers globally to increase funding for trade, growth and jobs.

We urge the BCBS to reconsider these proposals and take into account the impact on lending and trade as well as data from the QIS exercise. One possible reason for this disconnect between the proposed calibration and the historical data may have been due to differing jurisdictional practice around definitions and through-the-cycle versus point-in-time calculation.

It should also be noted that inflated CCFs will not only result in artificially RWA figures in this framework, but will also inflate bank balance sheets for leverage ratio purposes. Our initial internal calculations suggest that the proposed CCFs could result in up to a 15 basis points decrease in bank leverage ratios. As has been discussed at length, the leverage ratio is a non-risk sensitive tool that can result in perverse incentives from a risk-taking and balance sheet allocation perspective – further enhancing its binding nature through apparently inaccurate CCFs in the SACR framework would be a very negative, and easily avoidable, consequence.

Some figures that could provide guidance to the BCBS in terms of calibrating these CCFs better would be reported Exposure At Default. The accounting value of the market produces an average CCF factor of between 28% and 32.5% for investment grade revolving credit facilities – the BCBS proposal suggests 70% would be appropriate.

The Institute of International Finance provides some options for a more granular and accurate breakdown of CCF buckets which we have contributed to and strongly support. We would urge the BCBS to consider these as a simple way to improve the framework, along with recalibrating the proposed CCFs to ensure they reflect real economic data. We believe that calibrating this section of the SACR is crucially important.

Real Estate Exposure Class

Valuation Approach:

The proposed property valuation approach, whereby potential reductions need to be applied to the market price to prudently reflect a 'yet unknown potential reduction in value' is overly



onerous. In addition to the sensible approach of including a prudent valuation, the proposal would add valuations under distressed markets. Whilst this would be appropriate for a pillar 2, stress-testing provision, it is not appropriate for a pillar 1 requirement like the SACR.

The BCBS should consider EU regulation¹ (No. 575/2013) which implemented the concept of 'Mortgage Lending Value' (MLV) in 2013. We believe the MLV to be a well designed, simple and conservative approach to the valuation approach.

Furthermore the proposed approach is inconsistent with established market norms. For example the Commercial real estate business internationally tends to follow the Royal Institute of Chartered Surveys (RICS) standards which use market values. We would urge the BCBS to consider where RICS can be sensibly leveraged.

Valuation Timing (At Origination):

Real estate valuations are subject to change due to specific and market conditions. For this reason, the use of up-to-date valuations should be a basic requirement for prudential requirements. The current proposal to use valuation at origination is likely to lead to divergence between banks risk management practice and capital calculations.

This could also lead to inconsistency between banks. As property values fluctuate, different capital requirements would apply for same risk in different banks depending on when the loan or mortgage was granted. To avoid this, we recommend the SACR using the latest available Loan To Value (LTV).

Eligible Financial Collateral:

In line with our response to the first consultation, we maintain our opinion that LTV calculations should be adjusted for eligible financial collateral that might be provided in addition to the real estate collateral, whereby these amounts would be netted from the loan amount in the LTV calculations. This collateral (subject to regular valuation review/validation) from our perspective fully qualifies as eligible collateral for this purpose.

Eligibility Criteria regarding Claims:

The BCBS proposal requires that 'each bank holding a lien on a property can initiate the sale of the property independently from other entities holding a lien on the property'. This criterion does not take into account standard legal structures found in many jurisdictions whereby inter-creditor agreements may sometimes constrain the creditors' rights to immediately initiate proceedings, perhaps with a requirement to permit one of the creditors to buy out the other creditor. This type of constraint should be permitted and recognised. For example in the US, it is possible for a senior lien holder to sell at a discounted value to the detriment of the junior

¹ EU regulation No 575/2013 states that mortgage lending value "means the value of immovable property as determined by a prudent assessment of the future marketability of the property taking into account long-term sustainable aspects of the property, the normal and local market conditions, the current use and alternative appropriate uses of the property".



lien holder - if they act unreasonably they would likely be held liable for the losses their action cause to the other creditors or equity holder.

Clarity in Definitions:

We would appreciate further clarity around the following definitions:

- 1) Income producing real estate: The BCBS proposal splits risk weights based on income producing real estate versus where repayments are not materially dependent on cash flows generated by property. The definition needs more detail about interpreting materiality in this context and further clarity on how to categorize situations where multiple properties secure multiple debt facilities.
- 2) Finished property: We would appreciate further clarity on how to define 'full completion'. In our view, the standard should be physical completion or the existence of a regulatory approval to occupy the property for its stated purpose. The US has a 'Certificate of Occupation'; other jurisdictions have similar concepts which can be used.

Risk Weight Levels:

The BCBS has stated that increasing overall capital requirements under SACR is not an objective. However, the new criteria would mean significantly higher capital requirements. This is particularly the case when looked at in conjunction with the forthcoming capital floor. Moreover, partial risk weightings for collateralised loans are higher than uncollateralised loans. This sets perverse incentives and goes against the principle in paragraph 1042.

- 1) Mortgages: Overall RWA proposals for mortgages lead to significantly higher RWA and discourage banks to originate low-risk mortgage business. Furthermore we do not see evidence that cash flow producing real estate is that much riskier compared to owner-occupied mortgages.
- 2) Land acquisition, development and construction: For these exposures more onerous risk weights are proposed in the consultation paper. Finished properties may be purchased and financed at a time when their cash flow is sub-optimal and more onerous treatment of development opportunities would discourage lending and real economic activity in these sectors.
- 3) Commercial Real Estate: Bank lending continues to play a critical role in this sector. Whilst we appreciate the Committee's need to maintain simplicity in the risk weight method, we suggest increasing the granularity of the risk weight method and propose a framework for an alternative method which allows for the mitigation of the cliff effect in risk weights.

Commercial Real Estate (CRE):

² "104. No transaction in which CRM techniques are used shall receive a higher capital requirement than an otherwise identical transaction where such techniques are not used."



Bank lending continues to play a significant role in financing a critical sector of the economy, particularly as the demand for new developments and urban regeneration increases. Bank debt finance is a critical means of meeting this demand. It is therefore important that the CRSA framework does not veer too far towards simplicity and away from risk sensitivity that it incentivises bad risk decisions. The Basel capital framework needs to incorporate a suitable incentive system that helps to promote robust risk management practices and the appropriate pricing of such risks through the property and credit cycles. Whilst the current focus on Loan-To-Value (LTV) is an improvement over the initial approach, LTV alone only provides a partial risk picture. It provides an indication of loss severity but does not fully reflect the default probability.

Additionally, the current proposal creates a “cliff effect” in risk weightings as a loan moves from one LTV “slot” to a higher one. This will result in a bifurcation of the lending market between banks and shadow banks as bank lenders will only be competitive with shadow bank lenders for loans with LTVs towards the higher ends of each LTV slot. For instance, if a commercial mortgage loan of 60% LTV needs to be priced at a margin of 200bps to achieve a bank’s target return on regulatory capital, that margin would have to rise by 25% to 250 bps if the bank were to increase the loan amount by €1. The bank would be very uncompetitive with respect to shadow banks on this marginally higher LTV. The bank could maintain that higher 250bps margin as the leverage of the loan increased until it reached 80% LTV and so it would be able to compete with the shadow banks for loans towards 80% LTV the upper bound of that LTV slot.

We present two proposals as refinements to the current risk weight methods.

(A) Extension of the LTV buckets set out with Table 12 of Annex 1:

We would suggest that risk weight the proposed LTV buckets be expanded by 1 lower bucket ($LTV \leq 40\%$) and 2 higher buckets ($80\% < LTV \leq 100\%$; and $LTV > 100\%$) as highlighted below:

Table 11	LTV $\leq 40\%$	$40\% < LTV \leq 60\%$	$60\% < LTV \leq 80\%$	$80\% < LTV \leq 100\%$	LTV $> 100\%$
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The above refinement will lead to a better reflection of risk and in addition to mitigating cliff effects will encourage more prudent lending.

(B) Alternative Method to mitigate the risk weight cliff effects shown in proposal (A):

To maintain a simple but smoother bucketing system, in particular for lower leveraged loans, within each LTV slot we would propose that higher risk weights be applied to the incremental increases in the size of a loan secured by a property of a given value rather than to the entire loan as the loan moves from one LTV slot to another. Such an approach would allow for lending to be maintained within the regulated banking market and preserve (if not enhance) market liquidity. We provide an example below.



An “Alternative Method” is proposed where a loan secured by commercial real estate is notionally segmented into “LTV Bands” and a weighted average risk weight determined. This will allow for a measured increase in risk weight granularity and only be available for those banks that demonstrate appropriate credit due diligence and assessment. This proposed approach will allow for the mitigation of the cliff effects seen within the LTV bucketing approach.

The aforementioned due diligence requirement is similar to the approach to risk weighting of bank exposures as set out under Section 4 of Annex 1 of the consultation paper.

The method of risk weighting notionally divides the loan into bands of increasing LTV and assigns higher risk weights to higher LTV Bands reflecting the fact that the riskiness of each additional Euro of debt goes up with the loan balance. The risk weight for the loan is then the weighted average of the risk weights for the constituent notional bands.

Where the requirements in paragraph 50 are not met, the proposed 150% risk weight is too punitive compared to the counterparty risk weights for Other Retail (100%) and SME unrated corporates (85%). This is equivalent to a risk weight for defaulted unsecured exposures (i.e. 150%). We would propose a risk weight of 75% for individuals and 85% for SMEs. This is consistent with the assumption that the exposure is unsecured and has not defaulted.

Example calculation for illustrative purposes:

A single loan of €65 collateralised by a single commercial property with a current market value of €100 (LTV of 65%) where the repayment is materially dependent on the cash flows generated by the property would have a risk weight of 100% under the current proposal, risk weighted exposure value (“RWA”) of €65.

Under the proposed Alternative Method where the loan can be notionally segregated into LTV bands the risk weight would be 60% as shown below

Example LTV Bands in the below table are used to illustrate the calculation method

LTV Bands (%)	RW
40	45%
60	80%
80	100%
100	110%
> 100	130%



LTV Bands (%)	RW	Cumulative Loan Amount	Incremental Loan Amount	RWA
40	45%	40	40	18
60	80%	60	20	16
80	100%	65	5	5
100	110%	0	0	0
> 100	130%	0	0	0

Total Loan Value	65	RWA for Total Loan Value	39
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Risk Weight for the Total Loan	60.00%
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Where the Cumulative Loan Amount is determined by the product of:

- The LTV Band; and
- Collateral value.

The above resultant value is capped at the Total Loan Value.

The Incremental Loan Amount is the:

- Cumulative Loan Amount corresponding to the LTV Band immediately below; less
- Cumulative Loan Amount corresponding to the LTV Band in question.

Jurisdictional Differences:

The proposal regarding real estate as an exposure class does not take into account important jurisdictional differences. This is particularly relevant when combined with the BCBS's work on a potential floor for the IRB approach, as this will ultimately lead to different effects in different countries. We ask the BCBS to keep in mind that finding a way to incorporate this additional level of granularity would make the framework considerably more risk sensitive and reliable. Failure to do this would impact on residential mortgage markets which are already under significant pressure from provisions such as the leverage ratio which disproportionately impact on this low-risk business. This is particularly important in jurisdictions such as the EU where there are no equivalents of Fannie Mae and Freddie Mac to take mortgage exposures off bank balance sheets. A relatively easy way of accounting for regional differences would be to permit the use of loss experience by jurisdiction to be included as a risk driver – this would also enhance the level of comparability between banks operating in various jurisdictions.

Bank Exposures



We welcome the reintroduction of the use of external credit ratings and recognition by the BCBS of the limitations of the two risk driver approach. The introduction of simple hierarchy of approaches reduces the level of interpretation needed and supports a level playing between institutions.

We support the BCBS proposal to incorporate own due diligence requirements, which we already conduct on banking book exposures as part of initial credit approval and subsequent periodic reviews. This is a prudent measure that allows banks to incorporate any credit concerns, in addition to those captured in external ratings. Incorporating concerns captured from these reviews into Risk Weighted Asset (RWA) calculations ensures consistency in bank credit analysis and capital calculations. We do, however, believe that where a thorough due diligence process suggests that a different risk weighting would be prudent and accurate, that this option should be available, both for increasing and lowering the rating provided by the external rating agency.

In order to maintain the proportionality and simplicity of the framework, the due diligence requirements institutions undertake when using external ratings should not be additive to Internal Rates Based Approach (IRBA) requirements.

External Credit Risk Assessment Approach (ECRA)

While we understand the policy objective of breaking the negative feed-back loop between banks and sovereigns, we do not believe that attempting to do this through the SACR framework is appropriate or workable. Although we understand that certain Credit Ratings providers are currently working to offer a comprehensive list of ratings that do not factor in sovereign support, this is not currently available in a consistent and reliable form. We ask the BCBS to reconsider mandating that banks front-run this process. In addition to Ratings Agencies changing their offerings and infrastructure, data vendors will also be required to make these changes.

We would additionally flag that we strongly support the policy objective of removing sovereign support for banks and ending too-big-to-fail. Vast progress has been made in this area in almost all jurisdictions. Indeed the practical measures (Bail in, Recovery and Resolution) taken by authorities in many markets to reduce reliance of banks in stress on tax payers is already reflected by rating agencies in their rating assessments. In these jurisdictions the BCBS objective is already met. However, there are certain markets where progress has been slower and sovereign support is still a factor in determining credit worthiness.

Standardised Credit Risk Assessment Approach (SCRA)

The BCBS proposal to introduce three buckets for assigning risk weights to bank exposures where external ratings are not available or cannot be used is an improvement over current approach of applying a flat risk weight for unrated exposures. This approach enhances comparability and risk sensitivity while not being overly complicated or onerous to implement. However, banks operating in the SCRA framework may be disadvantaged over those using



the ECRA as the buckets permit a less granular, and more conservative risk weighting. As per the views expressed by The Clearing House (TCH), we believe that the BCBS should find a way to increase the granularity here to ensure a more level playing-field globally.

Risk Weight Floor

Adequately capturing top down macroeconomic and jurisdictional risks is fundamental to the global consistency of the SCRA. The BCBS proposal to include a risk weight floor based on sovereign exposure is a simple but adequate measure that can ensure some consistency.

Corporate Exposures

As with bank exposures, we appreciate the BCBS's reintroduction of external ratings for determining the credit risk of certain corporate exposures. However, we question the application of the hierarchy of approaches designed under the bank exposure framework to corporate exposures.

In particular, for rated corporate exposures, the application of due diligence standards as defined by the consultation should take into account the credit review performed under the standards of the IRB approach. As per the comments on bank exposures, these due diligence requirements should have the possibility to result in either an increase or decrease in risk weightings, where prudent.

Investment Grade

The definition of investment grade in paragraph 173 makes reference to certain conditions that we do not believe are applicable when assigning a rating to an investment grade corporate bond. Further, the share of corporates with securities outstanding on a recognised securities exchange differs significantly between jurisdictions. To mitigate this issue, the BCBS should consider allowing national regulators to define additional criteria that fit better to the local environment.

We agree with the International Institute of Finance view on this that banks have the ability to identify objective criteria to classify corporate counterparties into credit risk grades. Ensuring comparability in how bank and corporate exposures are examined will help foster consistency across banks and jurisdictions with regard to credit risk review.

Subordinated debt, equity and other capital instruments

We welcome the improvements that the BCBS has made in this area when compared to the initial proposal.

We do, however, question the reason for applying a 250% risk weighting for equity – this seems disproportionately more punitive than the 100% weighting for unrated corporates or



the 150% weighting for subordinated debt. We would request that the BCBS reviews this once the QIS data is available, as this 250% weighting does not appear to adequately reflect experience in the market. We share the view expressed by the Institute of International Finance that using an add-on assigned to senior exposure would be a simple way to improve the level of risk sensitivity.

Further, the Basel Committee should continue provide national discretion for supervisory authorities to provide for lower risk-weights in certain circumstances. Specifically, we believe that the Basel Committee should continue to provide for national discretion to provide for a lower risk-weight for banking organizations that have non-significant equity exposures that do not exceed 10% of the Bank's total capital and that are not subject to an equity capital deduction. We note that in certain jurisdictions, such as the United States, a banking organization's ability to hold the equity securities of a company is strictly limited and generally requires them to hold the securities for business rather than investment purposes. Given these strict investment limitations and materiality threshold that limits the amount of holdings that are eligible for the lower risk-weight, we believe that the Basel Committee should provide for national discretion to apply these lower risk-weights.

Likewise, many jurisdictions, including the United States, have legislation that is designed to promote investment in the equity of community development or other organizations. The application of the 250 percent risk-weight to such exposures would unduly penalize banking organizations that, in accordance with these national goals, seek to invest in organizations promoting public development. Accordingly, to permit the continued incentivizing of these investments, we request that the Basel Committee provide sufficient national discretion to allow for the preferential risk-weighting of equity exposures to community development or other public interest organizations.

Exposures to multilateral development banks (MDBs)

We welcome the approach and calibration that the BCBS has used in this revised consultation.

Risk Weight Add-on for Exposures with Currency Mismatch

Requiring a Risk Weighting add-on for currency mismatch for corporate exposures is not appropriate – we believe this should be removed as this risk is already taking into consideration during the external rating and due diligence phase. This will lead to a double-counting of the same risk, increasing cost with no associated benefit. It should additionally be kept in mind that corporates typically hedge their currency risk.

The operational complexity of identifying potential currency mismatches when talking about investments in debt securities, where underlying cash-flows may be extremely difficult to identify also need to be kept in mind. As per the TCH letter, these same complexities exist when looking at exposures to corporates operating in multiple jurisdictions with many different currencies.



For residential real estate exposures (RRE), we would recommend making a distinction between types of borrowers. For example, in the Wealth Management space, this proposal would not be deemed appropriate to apply to borrowers classified as High-Net-Worth Individuals or Ultra-High-Net-Worth Individuals. For this type of borrower, the currency of the loan being different from that of the borrower's main source of income is less relevant and does not justify such an add-on for the purpose of RWA calculation. For this type of borrowers, banks can rely on more extensive and generally more diversified wealth than for retail clients, largely limiting this risk.

Finally, for the remaining RRE exposures and for Retail clients, we believe that the proposal currency mismatches should not be applied to all existing portfolio but only to new loans. To apply the proposal to existing portfolio would place substantial operational burden as information on currency of income is not captured in systems feeding RWA calculations.

Corporate Sub-Asset Class - Specialised Lending

The BCBS revised calibration takes into account the need for a specific specialised lending regime, which we appreciate and agree with. However, the proposed calibration for certain specialised lending exposures where an issue specific external rating is not available indicates higher losses than other corporate exposures which diverges from available market data. Following sub-sections set out proposals for project finance and object finance (aviation and rail) exposures.

Project Finance:

Establishing a balanced and more granular risk weight framework will ensure that bank lending continues to play a significant role in financing a critical sector of the real economy, which is expected to see unprecedented future funding needs for greenfield and brownfield infrastructure investments. The Global Commission on the Economy and Climate estimates the global funding demand of infrastructure projects at USD 89 - 90 trillion (real 2010) in the time period from 2015 - 2030.

Commercial banks continue to perform a vital role in structuring and providing market making and underwriting services in debt finance to transactions. Hence bank debt remains a critical means of meeting the expected future demand and facilitating the access of investors to the Project Finance asset class.

Moody's study on "Default & Recovery Rates for Project Finance Bank Loans, 1983-2013" ("Moody's Study"), which covered around 60.6% of all Project Finance transactions originated globally during the 31 year period, does not appear to support the proposed risk weights of 150% and 100% for pre-operational phase and operational phase respectively across all Project Finance exposures. Based on historical loss experience as outlined in the Moody's Study, the ultimate average recovery rates for Corporate Bank Loans (all loans) is 80.3%, Corporate Bank Loans (senior secured loans) is 84.8% and the Project Finance Loans (Basel II definition) is 80.3%. Specifically:



- Pre-operational phase: Moody's found that average default rates in early years of Project Finance transactions, coinciding with the average duration of construction phases, are higher compared to corporates rated Baa (i.e. investment grade), but have default rates which are similar or even lower than corporates rated Ba (sub-investment grade). Average recovery rates during construction of Project Finance assets were marginally below general recovery rates in the corporate debt sector.
- Operational phase: Moody's found that marginal default rates of Project Finance transactions are considerably lower than default rates of corporate exposures rated Ba and after a certain number of years even drop below default rates of corporate exposures rated Baa. Average recovery rates during the operational phase were equal to general recovery rates in the corporate debt sector.

The application of just two risk weights does not properly reflect the distinctness of sectors and structures in Project Finance lending transactions. Respecting the BCBS aim to maintain simplicity, we propose that another dimension be added to the Project Finance risk weight framework to recognise and incorporate a suitable incentive system that helps to promote robust risk management practices and the appropriate pricing of risks.

Empirical evidence suggests that PPP/PFI transactions have below average default and recovery rates when compared to standard Project Finance transactions once the pre-operational phase has been completed and as such should receive a risk weight that reflects the low risk nature.

The table below summarizes proposed categories and the relative riskiness compared to corporate exposures:

Construction		Operation
Standard PF	Similar risk to Corporates rated Ba to Baa	Similar risk to Corporates rated Baa
PPP/PFI	Similar risk to Corporates rated Ba to Baa	Lower risk to Corporates rated Baa

The Basel Committee also invited banks to comment on the definition of the phases of Project Finance transactions. In that respect, we would like to note that lending to operational projects does not necessarily entail amortising debt structures, e.g. bridge financings. Hence the requirement to have a decreasing debt balance should be deleted from the definition.

Object Finance - Aviation and Rail Financing:

According to industry data (Boeing / Airbus³) c. 30% of new delivery financing in 2014/15 was provided by banks (i.e. US\$115bn in 2014 and US\$124bn in 2015). Bank debt also supports

³ Data from the Boeing Capital Corporation titled, "Current Aircraft Finance Market Outlook 2015".



refinancing of older aircrafts and in some instances supports capital markets issuances as well, so plays a crucial role.

The application of LTVs is a fairly straightforward approach to differentiating across object finance exposures which focuses on the extent of loss that might be borne by a lender after taking into account the collateral. However, LTV alone does not give the full risk view as it does not provide a complete picture of the cash flows generated by the collateral. For example, the attached lease in aircraft financing can have significant value and therefore a more broadly operated aircraft will be lower risk for any given LTV, as the ability to generate cashflows from that asset will be greater.

To maintain banks' competitiveness with shadow banks across the LTV spectrum and in particular for lower leveraged loans within each LTV bucket we would propose that risk weights applied based on the below LTV buckets where a LTV greater than 100% would result in a risk weight of 120%.

Similar to the conditions set out for real estate exposures to use the above table the following criteria would need to be met:

- Operating Assets
- Legal Enforceability – Claim on the assets to be legally enforceable in all relevant jurisdictions.
- Claims Over the Assets – Claims over the assets are restricted to where the lender bank holds a first lien over the aircraft and any sequential lower ranking lien(s).
- Ability of the Borrower to Repay – the underwriting policies must define metric(s) and specify its corresponding relevant levels to conduct such assessment.
- Rail - Typically lessors have a high number of assets in their portfolio. Lenders monitor the off lease proportion of the portfolio by utilization tests. In addition where utilization tests are not included minimum Fixed Charge Cover Ratios are included in order to ensure a minimum level of free cash flow resulting from the lease income of the portfolio.
- Prudent Value of Asset – Valuation principals to include use of generally recognised expert independent valuers.
- Required Documentation – All information required at loan origination and for monitoring purposes should be properly documented, including information on the ability of the borrower to repay and on valuation of the asset.

A similar approach could be applied to financing in the shipping and maritime industry.

Retail portfolio

Whilst we believe that the proposed 75% risk weighting is broadly appropriate and should be maintained, we believe that, in view of the potential homogeneous application of a Capital Floor capturing credit risk, this could result in negative impacts on lending to high quality retail clients.

Default Exposures



We support the approach of better aligning the Standardised Approach definition of defaulted exposures with that used in internal models. With respect to changes in risk weighting, we would welcome the Committee providing about which concerns with the current approach led to the proposed changes.

Again here, the Institute of International Finance has detailed comments which we agree with. We particularly share the views they express around the proposed flat 150% risk weighting (lowered to 100% for residential real estate exposures).