

Date 23 June 2016

Reference NVB response to the BCBS Consultative Document: “Reducing variation in credit risk-weighted assets - constraints on the use of internal model approaches”.

To Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2, CH-4002 Basel, Switzerland

Dear Sir/Madam,

We welcome the opportunity to provide feedback to your Consultative Document: “Reducing variation in credit risk-weighted assets - constraints on the use of internal model approaches”.

After the executive summary, this consultation response provides a detailed and constructive response to the main chapters of the consultation document.

1. Executive summary

The 2016 BCBS proposals lead to significant capital increases whereas it has been stated that overall the impact would be not significant.

In January 2016 the GHOS indicated that the Committee will focus on not significantly increasing overall capital requirements. Based on the most recent BCBS publications (final standards for market risk and consultations for operational and credit risk¹, including capital floors) the capital requirements for the Dutch institutions, however, would increase very significantly. We have heard the same message from many other European and other banks. We note that the IRB revision will also have significant consequences for the capital buffers, TLAC² and the Leverage Ratio³. Therefore, a substantial change of the current proposals is required to realise this GHOS goal.

Based on these BCBS proposals significant capital increases are seen primarily within higher quality portfolios such as Specialised Lending (including Infrastructural Project Financing and International Trade Financing), highly collateralised lending (Corporates, Agri-financing, Leasing and SME lending), lending to Banks and Income Producing Real Estate. In sum, the BCBS proposals in practice have a very significant capital increasing impact. Subsequently we fear a significant negative economic impact as the availability of credit to the real economy could deteriorate, and the pricing of several products could go up.

The BCBS states⁴ that the SA framework should be seen as credible fall-back alternative if IRB cannot be used. The Dutch banks are of the opinion that when sufficient data is available A-IRB should be preferred, instead of denying the use of A-IRB for certain exposure classes (or subset

¹ The Dutch Banking Association responded to the SA consultation in March 2016.

² TLAC = Total Loss Absorbing Capital. As a result of these BCBS proposals not only a substantial increase of (equity) capital would be required, via the increases of the risk weighted assets (RWA) it would also require a substantial increase of (other) TLAC-eligible instruments.

³ Through the proposed changes to the Credit Conversion Factors (CCFs) for undrawn commitments under F-IRB and SA (compared to A-IRB and compared to the current CCFs under F-IRB and SA), the exposures will go up.

⁴ <http://www.bis.org/press/p160111.htm>: “A revised standardised approach that serves as a credible fall-back and floor to the model-based approach...”

thereof) without clarifying the minimum data requirements. Although the A-IRB is the preferred credit risk framework, further improvements to the A-IRB framework are required to further reducing the unintended risk weight variation.

- We suggest keeping **exposures to banks and larger corporates** on A-IRB if the data to build robust internal models meets certain minimum requirements.
- **Specialised Lending** benefits from sound risk management and monitoring practices. Together with data, this knowledge should be allowed to be factored in to make robust internal models, which are much better capable of reflecting the risk profiles than the Slotting Approach or the Standardised Approach.
- We are of the view that A-IRB **input floors** will not address unintended risk weight variation properly. Nevertheless, it could serve to address potential underestimation of risks, if the input floors are calibrated based on the data availability and the performance of the internal models. Highly collateralized transactions and high quality exposures, which might be floored under the BCBS input floor proposals, should not be put on a disadvantage compared to other riskier transactions that will not be floors by the input floor proposals.
- A **Capital Floor** (output floor) does not improve the overall capital framework; as it will weaken the link between risk profile and capital by overwriting the A-IRB framework. A Capital Floor is clearly not needed next to the Leverage Ratio and on top of the IRB revisions to the capital framework. The capital increasing impact, even calibrated at 60%, would be very significant for Dutch banks, due to the lower risk and lower IRB risk weights mainly within the Dutch mortgages books

We are very much willing to continue to collaborate with the BCBS and local supervisors to address the root causes of unintended risk weight variation in a way that would not hurt justified risk variation.

2. Introduction

2.1. Timing versus accuracy

1. Compared to all the BCBS standards that were published in the last couple of years, the IRB revision seems to have one of the largest capital impacts. Nevertheless, the timelines that the BCBS communicated are so tight that we fear that due to time constraints sub-optimal decisions could be taken. In the coming 6 months the BCBS is committed to make fundamental changes to the IRB revision and Capital Floors proposal in order to keep the GHOS promise. We suggest taking sufficient time in order to come up with balanced standards that contribute making the banking industry more resilient without unduly frustrating its role in the economy.

2.2. The Capital (output) Floor

We see no need for a Capital (output) Floor on top of the Input Floors, and the non-risk-sensitive Leverage Ratio.

2. **Capital levels have been increased, supervision has been strengthened.**
Since 2007 the capital quality and levels (CET1%) increased significantly over the globe, the capital definition strengthened, the minimum requirements of capital per unit of risk (CET1%) more than tripled (from 2.0% to 7.0%).

Also the rules how to determine RWA has been broadened (e.g. CCP, CVA) and strengthened (e.g. correlations for FIs). In the IIF report “Basel’s Evolution: a retrospective” (April 2016) the IIF indicates that it is often claimed that banks’ risk-weights have reduced while they’ve been using internal models (and that models are therefore just a way to reduce capital requirements); however, the post-crisis data reveal a different picture: the risk weights of the European GSIbS increased as from 2008.

As mentioned in the introduction, supervision has been strengthened and in Europe the supervision has been centralized, including increasing the number of on-site visits. The internal models have been scrutinized, stress tests and Asset Quality Assessments have helped improving the quality of data, risk management, reporting and modelling. As a back-stop the Leverage Ratio has been introduced. This long list of improvements strengthened the capital levels, also for A-IRB portfolios, and is likely to have reduced variability. Most recently, BCBS proposed to add A-IRB input floors.

On the back of all these developments, a Capital (output) Floor is not required from a capitalisation point of view, it will blur the link between risks and capital further and from that point of view will weaken the Basel Standards.

A Capital (output) Floor – even if calibrated at 60% - would increase the capital impact even further (on top of all the other BCBS proposals, including the revisions of SA and IRB) impacting the overall banking book, due to the lower risk and lower IRB risk weights mainly within the Dutch mortgages books.

The Capital Floor may even trigger sub-optimal portfolio allocation, pricing decisions and the availability of loans, which – at least on the long run – might contribute to market disequilibria, and therefore negatively affect economies.

3. Detailed response

3.1. Scope of use of Internal Models (A-IRB, F-IRB, SA)

A-IRB is the preferred framework and would benefit from further alignment in order to reduce unintended risk weight variation. F-IRB and SA should be credible alternative frameworks.

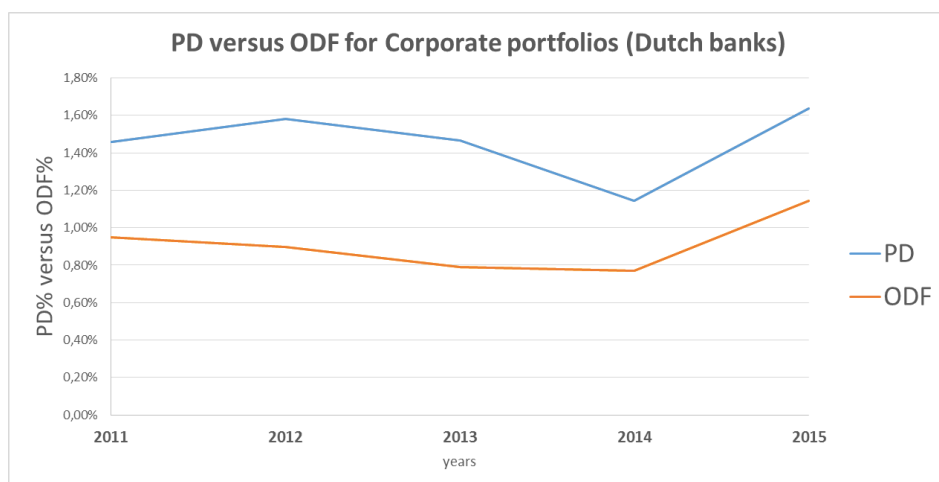
3. A-IRB models predict expected losses and are periodically back-tested.

Internal models under A-IRB estimate expected losses. Expected losses are periodically compared against provisions and actual losses. Through proper comparison over multiple years potential model under-estimation or over-conservatism are being identified and addressed periodically. These periodical internal model performance studies (loop-back) – including the studies performed by independent Model Validation units and by the supervisors (benchmark studies) – continuously lead to model improvements and keep these internal models fit for their intended use. This process contributes to the fact that A-IRB is perceived to be more reliable than the other credit risk frameworks to properly estimate the risk within portfolios of the bank. Therefore – in line with the GHOS statement (11 January 2016) – the other credit risk frameworks should serve as credible fall-back frameworks. Therefore we should be very mindful of overwriting the IRB based risk weights by input floors and/or output floors or by

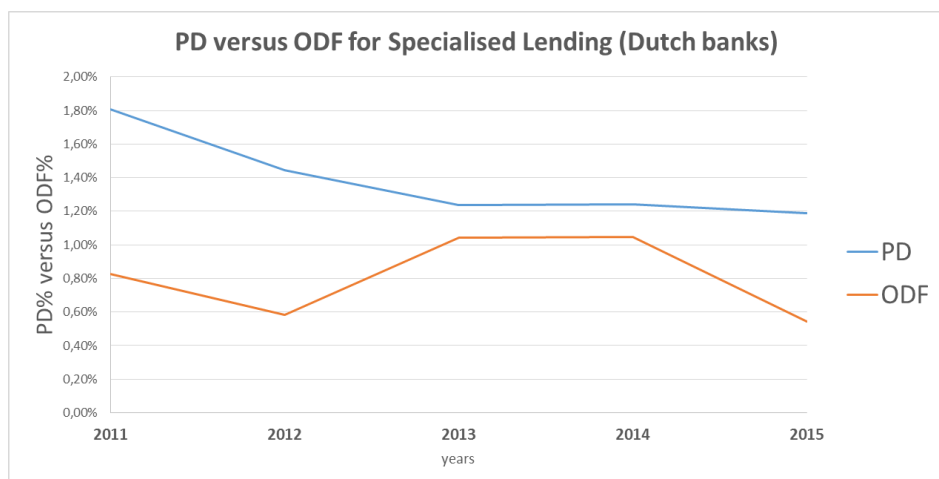
denying the IRB framework for complete exposure classes (or subsets thereof).

4. Dutch banks predict their PDs conservatively yet in line with the actual risks.

Graphs 1a and 1b show the yearly average probability of default percentages (PD) that the Dutch banks estimate and also the observed (realized) default frequencies (ODF). The graphs clearly show that the PD estimates are more conservative than the realized defaults (ODF). Also the two lines move in tandem, meaning that the degree of risk sensitivity is sound. The graphs are based on sufficient volumes (for Corporates over 6000 observations in every year, for Specialised Lending over 1000 yearly observations).



Graph 1a, estimated defaults (PD) versus observed defaults (ODF) for Corporate portfolios at Dutch banks
Source: data provided by the largest Dutch Banks, covering over 70% of their large corporate portfolios⁵



Graph 1b, estimated defaults (PD) versus observed defaults (ODF) for Specialised Lending⁶ portfolios at Dutch Banks

5. AIRB models: integral part of the internal (risk) organisation.

Basel II accelerated the use of the internal models, which are not only used for calculating regulatory requirements, but are an integral part of the internal organisation. In line with the Basel Use Test, these models are used in transactions and portfolio decision processes,

⁵ The NVB collected data from the larger Dutch banks, targeting their largest models.

⁶ Covering Trade & Commodity Finance and Project Finance portfolios, representing approx. 50% of the SL portfolios.

including pricing questions. IFRS9 demands that for each portfolio internal models are in place to determine provisions. We view it as very important that the regulatory requirements are as much aligned as possible with the internal processes of the institutions.

6. Pooled data will strengthen A-IRB models.

We believe that banks' internal models are the best method to properly estimate the risk within portfolios of the bank. If there is a sufficient number of annual observations within a bank portfolio to build adequate internal model, these banks should be allowed to use the A-IRB framework. Besides internal data, pooled data from data consortiums like the Global Credit Data (GCD) consortium are currently used to improve the performance of internal models. The pooling of data could be further increased. Obviously, issues concerning data protection (only use anonymised data) and ensuring that the pooled data is representative for the internal portfolio are and should be addressed. Finally, besides data, institutions improve the performance of their internal models with non-quantitative information that is collected through the knowledge that sits within the institution.

7. Little variation observed in the ranking of risks between institutions.

The BCBS indicated in their publication concerning the Regulatory Consistency Assessment Programme⁷ that they observed little variability between institutions in the ranking of clients from low risk to high risk. There is an upward potential in this regard, something that is also recognized by the banks themselves. This ranking holds valuable risk-sensitive information, information that is not included within the SA framework, especially when these clients are not externally rated. We therefore strongly propose to include these internal ranking capabilities (as part of the current IRB models within institutions) in any risk weight methodology solution that the BCBS might propose in general, and specifically for the exposure class Banks, NBFIs and Corporates.

8. Introduce minimum data requirements for internal models.

We suggest that the BCBS complements its current standards with a minimum number of yearly observations (including pooled data) and minimum data quality standards that institutions should adhere to before their internal models can be used to calculate their minimum capital requirements based on A-IRB. Such requirements could be made more explicit, transparent and in some aspects more detailed.

When predicting the defaults directly (PD), the competent authority could articulate a minimum data requirement in the form of the minimum required number of default observations. When ranking the clients (hence, estimate a rating grade, rather than a PD) the data requirements should be based on the minimum required number of observations per rating grade. To rank clients less data points are sufficient than for PD estimation. The performance of the model should be decisive factor in determining how much data is sufficient. The British Prudential Regulation Authority (PRA)⁸ did articulate minimum data requirements.

⁷ BCBS – RCAP Analysis of risk-weighted assets for credit risk in the banking book July 2013: "There is considerable agreement across banks with regard to the relative default risk of obligors in the HPE; that is, when considering two different obligors, banks generally agree on which one should be rated the riskier."

⁸ PRA: Supervisory Statement | SS11/13. Internal Ratings Based (IRB) approaches. December 2013 (Updated November 2015)

Less data: apply margin of conservatism, input floors might have a function. More data: less margin of conservatism, less impact input floors should have.

If the number of observations used in the IRB model go up (above the minimum required level), the likelihood of underestimation of risk is further reduced. As such, we suggest that if the IRB model is based on more observations the margin of conservatism should be reduced accordingly. Also the impact that input floors might have on the IRB model should go down if the IRB model is based on more observations.

For all portfolios, for all Basel exposure classes, granting permission to use A-IRB models for calculating minimum capital requirements should in our view be based on clear minimum requirements, including the number of annual observations and the quality of data.

We view that the objective should be to have robust A-IRB models that can better estimate risks and translate these risks into risk weights compared to the fall-back methodologies (F-IRB, SA and Slotting). Therefore, we should not base the minimum number of yearly observations on statistically almost watertight requirements. This would close the door for too many A-IRB models that estimate the risks better than the fall-back methodologies, which will weaken the overall capital requirements. We should put the minimum data requirements into perspective: the capital ratio requirements (CET1%, Leverage Ratio) are not calibrated statistically watertight either, instead they have been set to provide adequate comfort in times of stress. The minimum data requirements for A-IRB models should be determined likewise.

9. Re-calibrate SA based on A-IRB data.

If, for certain portfolios, A-IRB can no longer be used, F-IRB and SA should be credible fall-back frameworks. We suggest that the BCBS re-calibrates the SA risk weights and brings these more in line with the underlying risks (based on QIS results and observed global default and loss data), in order to increase the comparability between the risk weights calculated by different credit risk methodologies and reducing the overall capital impact.

10. We should put the unintended risk weight variation issue in perspective.

Overall, since 2007 major steps in improving the capital framework have been taken (tougher standards, already implemented). The positive effects of all the improvements to the going concern and gone concern capital requirements are clearly much larger compared to the remaining hurdle of reducing the unintended risk weight variation. Therefore we should act carefully and not take too crude measures overhasty.

In 2013 BCBS published a detailed study⁹ on possible areas of unintended risk weight variation. BCBS stated that *“Much of the variation (up to three quarters) is explained by the underlying differences in the risk composition of banks’ assets, reflecting differences in risk preferences as intended under the risk-based capital framework. The remaining variation is driven by diversity in both bank and supervisory practices.”*

⁹ Regulatory Consistency Assessment Programme (RCAP). Analysis of risk-weighted assets for credit risk in the banking book. July 2013

11. Address the root causes of the unintended risk weight variation: further strengthen A-IRB.

As stated before, we strongly believe that A-IRB is the preferred framework. Therefore we are committed to team-up with regulators and supervisors to address the root causes of the unintended risk weight variation.

Roughly there are three steps in the process of determining risk weights that played a role in the unintended risk weight variation: First of all, the differences are partly due to too high level direction in the Basel Standards, which then were translated into local legislation. These translations led to divergence. Secondly, the local supervisors might have performed different degrees of scrutiny, which led to additional unintended risk weight variation. Lastly, institutions will have made different modelling choices that contributed to the unintended risk weight variation. All in all, we believe that the most impactful root causes are known and can be addressed in order to further reduce the unintended risk weight variation.

Reducing unintended risk weight variation: continue the process.

The BCBS, European Banking Authority (EBA) and the industry (IIF¹⁰) identified multiple areas where the A-IRB models could or should be more harmonized (more harmonized definitions in the fields of data handling and modelling), which would reduce unintended risk weight variation. These aspects are amongst others: Downturn LGD interpretation, definition of default (including materiality thresholds), counting days past due, applying margin of conservatism, credit risk mitigation capital for defaulted loans and PD/LGD modelling estimation assumptions in general.

Most of the elements have not been elaborated before in detail and we propose to work out these details rather than restricting or constraining A-IRB. We are committed to work together with the BCBS, EBA and local supervisors to further strengthen A-IRB.

12. We support the reform agenda from the European Banking Authority¹¹.

The EBA has been working on identifying the main drivers of variability in the implementation of IRB models, and will propose improvements to the IRB models through regulatory technical standards (RTS) and guidelines (GL). An example is the guidelines on the application of the definition of default. Through harmonisation the unintended risk weight variation will be reduced, which makes the risk weights genuine more comparable, something input floors or the SA framework shall not achieve.

3.2. Parameter floors (input floors on PD, LGD and EAD)

13. We support initiatives to reduce unintended RW variation, by addressing the root causes.

The BCBS intends to reduce the unintended risk weight variation, a goal we fully support. Nevertheless, we are convinced that there are better ways to address unintended risk weight variation than introducing input floors for all IRB portfolios. We kindly refer to the section “Scope of Internal Models” in which we suggest addressing the root causes of unintended risk

¹⁰ Institute of International Finance: IIF RWA Task Force (IRTF)

¹¹ EBA publications: “REGULATORY REVIEW OF THE IRB APPROACH” and “EBA OPINION ON THE IMPLEMENTATION OF THE IRB APPROACH REGULATORY REVIEW”(04-02-2016).

weight variation: the input of models, rather than harmonising model values (PD, LGD and EAD) by overwriting risk-sensitive information with fixed minimum values.

14. Input floors should only floor incorrect (too low) PD, LGD or EAD values.

A-IRB should be basis for establishing risk weights. In theory, input floors should only floor incorrect (too low) model values, they should not floor low PD and LGD values that accurately reflect the actual risks. Input floors that do not take into account the level of accuracy of the internal models could increase the unintended risk weight variation, especially where input floors will force banks to use the same risk weights for different risk profiles. Overwriting accurate risk-sensitive information will reduce comparability and misinform the investors. In the annex (paragraph 34) we included an example of possible negative effects of a floor.

15. Input floors should only be activated if model performance is below the minimum requirements.

We suggest including the performance of the model in the calibration process of the input floors. For PD models, the performance of the models should be assessed by comparing the predicted PDs to the observed default frequencies¹². For LGD models, the predicted LGD values should be compared to the actual losses. If the performance is sound (no underestimation of risks) the input floors should not be activated to the model. It should be the call of the Competent Authority (based on objective criteria from the BCBS) to activate input floors, triggered by evidence that the model for which the input floors are being activated are below a certain level of accuracy.

A simpler but less accurate approach could be to calibrate the input floors downward as the internal model is based on more observations, above the minimum requirements that we suggested in the section “Scope of Internal Models”.

Alternatively we propose the usage of a capital multiplication factor, similar to the approach used for market risk in the trading book. In case the realised PD, LGD or losses exceeded the predicted values by a certain amount, a capital multiplication factor larger than 1 should be applied. This decreases the unintended risk weight variation not only for the low default and low risk portfolios, but for all IRB portfolios and exposures.

16. Input floors should cover both low and high PD, LGD and EAD values.

Input floors that are activated and calibrated based on the level of accuracy of the internal model could address potential underestimation of risk for both lower risk portfolios and higher risk portfolios. The current BCBS proposal focuses on the portfolios with lower PD and LGD values, which often is an accurate reflection of lower risk assets. Therefore, the current BCBS proposal often does not address underestimation of risk, it simply increases the risk weights. That in itself would penalize lower risk portfolios and creates an unlevelled playing field. Over-collateralized transactions should not be affected by the same level of input floor, compared to less collateralized transactions.

¹² Please see paragraph 4 of this response document

As an example of a portfolio that will be impacted disproportionately is the secured and qualitative structured agri lending. The security in agri lending is warranted by a mortgage (on farm land/buildings) or a pledge (on crops/seeds/agricultural chemicals) requiring more moderate loan-to-values than applied in commercial/residential real estate financing. The agricultural portfolios have historically performed well, through the cycles, compared to non-agricultural portfolios. There is no reason to doubt the quality of collateral in the agri sector. Multi-year historic impairments and realized LGD levels are able to illustrate this. A-IRB should therefore continue to be allowed, as suggested in paragraph 13, assuming the sound performance of the models.

17. Input floors that only floor low model values could increase unintended RW variation.

Input floors that do not take into account the level of model accuracy will weaken the relation between actual risk and risk weights. For the stability of the financial system it is essential that the capital requirements are kept in line – to the extent possible – with the actual risks in order to support optimal transaction and portfolio decisions. This will reduce the number of situations in which clients will receive either too few or too many credits or pay too much or too little compared to the actual risks. These kind of market distortions could lead to undesired volatility in the economy.

3.3. Credit Conversion Factors

18. The BCBS definition of a commitment should (better) take into account the legal definition.

The definition that the Basel Committee has proposed for commitments raises concerns as the definition can be interpreted too broadly. Even arrangements that from a legal perspective do not constitute a commitment to extend credit whatsoever would be considered committed. Instead we propose that the definition takes into account the legal definition of a commitment. It should acknowledge that arrangements are uncommitted when a lender is at all times entitled in its sole discretion to accept or refuse to make any advances to the borrower under such arrangements, even if all conditions to make loans or other utilisations have been satisfied.

19. There are knock-on effects which should be considered before making final standards.

Another concern is that the definition of commitment is now provided in the context of IRB, without addressing the knock-on effects on other building blocks of the Basel Framework, including the Leverage Ratio. As such this consultation paper might not be the appropriate place for such a definition given the potentially far-reaching consequences.

3.4. Response per Basel Exposure Class

3.4.1. Banks and other Financial Institutions

20. A-IRB should be available to portfolios that meet minimum data and non-data requirements.

In line with the section 3.1 “Scope of use of Internal Models (A-IRB, F-IRB, SA)” of our response, we view that the decision to grant permission to use A-IRB should be based on a clear and transparent set of rules, focusing on sufficient ability to make robust models. Data quantity and quality as well as other minimum requirements, for example focusing on risk management,

should trigger such a decision. Therefore we do not support to deny A-IRB for all portfolios of exposures to Banks.

21. The SA risk weights for Banks should be re-calibrated based on A-IRB data.

The capital impact when moving these exposures to Banks and other Financial Institutions from A-IRB to SA will be very different per institution or per country. In Europe most of the exposures to Banks sit in the first three SA buckets (AAA to BBB-). The A-IRB risk weights for these buckets are substantially below the SA risk weights (CQS 1: 20% RW; CQS2: 50% RW, CQ3 3: 100% RW). Therefore the impact for West European institutions will be very significant.

We trust that the QIS results will show that especially the risk weights for the high quality clients and products are substantially lower under A-IRB compared to SA. In the SA consultation various respondents already advocated for splitting the highest SA buckets into more granular buckets, with re-calibrated lower risk weights. We kindly reiterate that allowing more granularity and sufficient lower risk weights for the higher credit quality clients would reduce the difference in risk weights between A-IRB and SA.

Based on the capital impact, the current proposal will incentivize institutions to reduce their exposures to other banks. This will make the interbank market less deep and therefore less liquid, which in times of downturn will lead to even more volatility. We think this macro prudential impact could and should be avoided.

3.4.2. Corporates

22. A-IRB should be available to portfolios that meet minimum data and non-data requirements.

In line with our comment made at the paragraph “Banks and other financial institutions”, the same holds for the larger corporates: the corporates with revenues above € 200 mln. Granting permission to use A-IRB models or denying the use of A-IRB should be based on clear minimum requirements, including the number of annual observations and the quality of data. Denying the use of A-IRB for all institutions, also those that do have adequate data to build and maintain robust A-IRB models is not proportional and economically not sensible.

The capital impact when moving these assets from A-IRB to F-IRB or to SA will be very different per institution and per country. In Europe most of the exposures to the largest corporates have an external rating between A+ and BBB-. The corresponding risk weights to these external rating buckets are significantly lower under A-IRB compared to under SA. Due to these potential higher risk weights the CET1% will drop. In some jurisdictions like to US, larger corporates might be less reliant on bank lending than smaller corporates, in many European countries, most large corporates are (partly) depending on bank lending, even the smaller group that is less dependent on bank lending still requires a variety of banking services for their day-to-day activities and to diversify funding needs.

To neutralise this CET1% drop, banks need to adjust their balance sheets (volume) and or need to strengthen their equity base. Both will have negative consequences for the clients. Such a negative impact could only be justified if underestimation of risks has been proven. We suggest that the BCBS closely studies the QIS results regarding large corporates.

23. Regarding corporates belonging to a larger group: BCBS proposals reduce comparability.

The BCBS proposes to force all subsidiaries belonging to a group company with revenues above € 200 mln (assets size below € 50 bln) to F-IRB, or to a larger group (assets size above € 50 bln) to SA, which will increase the unintended risk weight variation.

As an example, we plotted three (theoretical) companies with identical balance sheets and identical loans (size, tenor, collateral). Based on the size of the group the company might belong to, the regime (A-IRB, F-IRB or SA) might yield very different risk weights. In this example we assumed no guarantee or support from the parent company. The actual tenor in this example is set at one year. However, under F-IRB this is translated into 2.5 years. Under SA the tenor is not applicable. Also the CCFs can lead to a huge impact (going from A-IRB to F-IRB or SA). We ignored the possible impact of CCFs in this example.

Group Size	Revenues below € 200 mln		Assets below € 50 bln; Revenues above € 200 bln		Assets over € 50 bln	
Regime	A-IRB		F-IRB		SA	
External Rating	BBB+	BBB-	BBB+	BBB-	BBB+	BBB-
LGD	30% (Internal Model)		45% (Foundation)		information not used	
PD (BBB+)	0,15% (Internal Model)	0,35% (Internal Model)	0,15% (Internal Model)	0,35% (Internal Model)	lookup table (CQS3)	lookup table (CQS4)
Tenor	1 year	1 year	2,5 years	2,5 years	information not used	
Risk Weight (BBB+)	18%		44%		100%	
Risk Weight (BBB-)			68%		100%	

Table 2: Risk weight consequences when a corporate belongs to a larger group of different sizes. We assumed no guarantee structures

According to the proposal for Corporate exposures different risk weights are applied based on size of the parent, although the underlying risks are comparable. This clearly reduces comparability. In the first SA consultation document (December 2014) the BCBS proposed also to include size as a risk driver, be it the other way around: larger companies would get allocated a lower risk weight.

We suggest that the application of the regime (A-IRB, F-IRB, SA) should be based on the characteristics of the legal debtor instead of the characteristics of the group the legal debtor might be part of. Moreover, as indicated in the section 3.1 “Scope of use of Internal Models”, the ability to model should depend on meeting objective minimum requirements (including data requirements).

3.4.3. Specialised Lending

24. Capital impact

The largest Dutch banks report their Specialised Lending exposures¹³ under A-IRB.

- If these exposures would be reported under the Slotting approach, the risk weights would increase very significantly. In 2015 EBA published an European study¹⁴ on the usage of the Slotting approach. 70% of all European transactions were placed in the first two categories, leading to a risk weight range of 50% to 90%¹⁵. At best, most of the Dutch Specialised Lending transactions would end up with a similar range.
- The impact would be even more dramatic if the Standardised Approach would be applicable. Almost none of the transactions have an external rating. For Object and Commodity Finance a flat risk weight of 120% would be used, while Project Finance transactions would increase to 100% (post completion) or even 150% (pre completion).
- Currently the Specialised Lending exposures at Dutch banks are well above € 100 bln. We fear a significant impact on the volumes and pricing of Specialised Lending exposures, which could have an adverse impact on the economy.

25. Exposure class demarcation.

As the IRB revision proposal has a huge capital increasing impact on the Specialised Lending exposures, and it creates a larger gap in the risk weight determination between Corporates and Specialised Lending, it becomes more important to ensure a clear and objective demarcation between these two exposure classes. Also the increasing differences in risk weights should be examined. One of the anchor points in re-setting the risk weights should be that the ranking of assets from less risky to more risky – also between different exposure classes – is taken into account. Differences that cannot be explained by the underlying risk profiles should be corrected.

26. A-IRB is the best fit for Specialised Lending.

Specialised Lending involves structured transactions, including with a green labelled project, that are mainly focused on credit risk reduction resulting in a safer asset structure and as a result creating financial possibilities that are aligned with the interest of the client and even with the society. Due to its individual and collateralised approach, Specialised Lending is unsuited to standardisation.

Specialised Lending exposures are by nature highly structured transactions. A-IRB provides a platform to include these structures in the risk assessment and risk quantification. Through the PD, LGD and EAD models, the risk quantification includes non-financial covers, risk mitigating monitoring processes and in depth knowledge of the clients, the products and the markets. Hence, much more than a simple test of the performance of a model by only looking at historical data.

As stated in the section 3.1 “Scope of Use of Internal Models” of this response paper, the current internal models (PD, LGD and EAD) reflect the expected losses. These predictions are

¹³ Specialised Lending = Project Finance, Object Finance, Trade Finance and Commodity Finance

¹⁴ CP for the draft RTS on assigning Risk Weights to Specialised Lending exposures (11 may 2015)

¹⁵ A risk weight of 50% represents category 1, shorter than 2,5 years. A risk weight of 90% represents category 2, longer than 2,5 years

periodically tested against observed default frequencies and realised losses and, if needed, models are adjusted to ensure a sufficient level of accuracy, which make these models fit for their purpose (including calculating minimum regulatory capital requirements). Also these model outputs are an important ingredient for determining the provisions. We view that the decision to grant permission to use A-IRB should be based on a clear and transparent set of rules, focusing on sufficient ability to make robust models. Therefore data quantity and quality as well as other minimum requirements, for example focusing on risk management, should trigger such a decision. Within the area of Specialised Lending, next to quantitative aspects the LGD modelling is strengthened with qualitative aspects, such as in-depth market and product knowledge, including robust risk management and monitoring processes.

27. The Slotting approach could be a viable fall-back approach if improvements are made.

The BCBS proposes Slotting as an alternative for A-IRB. The Dutch institutions agree that the questions asked in the Slotting methodology could be seen as a viable fall-back approach for analysing Specialised Lending transactions. However, several sector and/or business related characteristics and developments can only be taken into account to a limited extent. Also Specific client or product knowledge at the management of the institution is hard to incorporate. In practice a transaction is assessed on asset class/sector specific criteria. Before Slotting can be considered as a viable fall-back alternative for A-IRB, we wish to propose the following amendments:

a. Additional tenor bucket, shorter than 1 year:

Currently Slotting has a tenor dimension with buckets above and below 2.5 years. Especially for Trade Finance we propose to add a third tenor bucket for remaining transactions below the 1 year, including lower risk weights for this short tenor bucket.

b. More granularity between the buckets will increase comparability:

The EBA performed a study on Slotting in Europe. Over 70% of all transactions that are risk-weighted based on Slotting were placed in categories 1 and 2. We would like to propose to increase the granularity by splitting both buckets into two sub buckets and to lower the risk weights of these slots to bring them more in line with the observed risk levels. As a result the best quality transactions should be able to benefit from lower risk weights. Comparable risks will receive comparable risk weights. It will increase true comparability.

c. Provide additional objectivity in the questions and answers:

Several questions in the Slotting approach can be interpreted in various ways. This will lead to situations in which institutions see similar risks but provide different answers. We suggest providing additional objectivity in the questions and answers. For example, the degree of over-collateralization could be made clearer in percentages.

d. Increase guidance re process from Slotting questions into Slotting category:

Currently there are multiple ways to translate the individual answers to all the Slotting questions into a Slotting category for the transaction at hand. Comparability will increase if more guidance is provided on how to categorize the transactions.

e. The Slotting should be facility level based rather than deal level:

The Slotting approach takes the implicit view that the risk weight can be determined on client/deal level. A Specialised Lending deal can comprise of several credit facilities, each

having its own credit risk profile and security package involved. We propose that the Slotting approach should be determined on facility level rather than on client/deal level.

f. Re-calibrate risk weights, improve ranking compared to other assets:

For the Dutch banks, the overall risk weights for all categories are significantly higher than the current risk weights under A-IRB. Supervisors receive valuable information on Slotting risk weights and the corresponding actual losses. The two (RW and actual losses) should be more aligned by lowering the risk weights per category. Besides, a further alignment and comparability of Specialised Lending with other exposure classes is highly recommended. In this alignment process the ranking of non-Specialised Lending assets should be included. The current situation is that Corporate Lending with a certain degree of collateral (including SME lending) will receive lower risk weights (also under SA), compared to the risk weights under Slotting, while the actual losses within Specialised Lending are lower compared to the actual losses within the Corporate portfolios.

An example of misalignment between corporate loans and Specialised Lending is seen between income producing real estate finance (IPRE) and commercial real estate (CRE) loans. Although both loans are related to the same asset class, CRE security will be, in most cases, seen under the Corporate Lending model (mostly A-IRB/F-IRB) receiving much lower risk weights than IPRE under the Slotting Approach with risk weights varying between 70% and 250%.

28. SA is not able to translate the unique transaction specific risk profile into a risk weight.

In line with our previous response related to the BCBS SA consultation, almost none of the Specialised Lending exposures have issue-specific external ratings, hence almost all of these exposures would receive the proposed flat risk weights [120% / 100% or 150%]. The transaction-specific risks cannot be translated into a flat SA risk weight. The Standardised Approach risk weights for the Specialised Lending exposures seem to focus mainly on the probability of default (PD) side (which partly could explain the proposed high risk weights), while the actual Specialised Lending risk profiles are to a large extent based on the (non-financial) collateral and non-collateral risk mitigating structures on the loss given default (LGD) side. Specialised lending exposures are subject to tightly managed, self-liquidating and/or secured structures. For many years, the institutions have invested in in-depth product and client knowledge, robust (risk management) processes, monitoring & controls and transaction structures, which led to a positive development regarding to losses that are reflected in the IRB risk weights. We should undertake a collective effort to make the models more transparent and clarify how these models work, instead of simplifying the structure and losing the distinctive power of the risk assessments which is currently applied in the models.

The Standardised Approach does not recognise these risk mitigating factors and allocates equal risk weights to higher risk and lower risk transactions. Crucial information related to the actual riskiness is not translated into the risk weights and therefore not translated into the CET1%. The Standardised Approach proposed for Specialised Lending, by comparison with corporate lending, breaches in a major way the principle that lower credit risk loans should carry lower credit risk capital. Account should be taken of the existence or quality of collateral or contractual rights surrounding a project or a real estate financing, relative to unsecured corporate lending.

As an example, if Specialised Lending would move to SA, a loan to an airline without security on an aircraft would receive a lower RW than a loan with an Specialised Lending structure, i.e. with a 1st lien security on the aircraft. This example appears to give a negative contribution to the value of collateral, even though lending for an aircraft on a 12-year full pay-out lease is better than unsecured lending to the airline. In other words, under the SA the ranking of risks seems incorrect if Specialised Lending and unsecured corporate lending is compared. Hence, the proposed SA revision will reduce the actual comparability and will provide incorrect information signals to investors.

29. There is a risk for the market if regulatory rules deviate too much from the actual risks.

There is a risk that riskier transactions and less sophisticated Specialised Lending teams (outside the regulated domain) will benefit from the lack of risk sensitivity. Most probably the total risks in the economy will increase due to less solid structures, and the more sophisticated specialised lending teams will be pushed out of the market. Also there is a risk that more lending will be done on an unsecured lending basis, which would lead to lower risk weights, but higher risks.

In Europe the capital markets are not able to take over large volumes of Specialised Lending transactions, which are often individually structured.

30. Specialised Lending clients belonging to a corporate group with assets exceeding € 50 bln.

The BCBS propose that borrowers qualified as Specialised Lending belonging to a large corporate group with assets exceeding € 50 bln shall be treated under the Standardised Approach for Corporates. In line with the suggestion made under section 3.4.2 “Corporates” above, we suggest that also Specialised Lending clients should be excluded from these corporate group proposals.

3.4.4. Corporate and Retail SME lending

31. Reduction in RWA variability.

As the QIS data will show, the actual risks do substantially differ per country, especially for the retail and the SME clients. Setting floors globally will simply hit some countries, while other riskier countries will not be hit at all. As a consequence, within lower risk countries the risk weight variation decreases, while the underlying risks might differ. On the other side, in riskier countries the alleged unintended risk weight variation is not addressed at all. For both groups of countries (lower risk countries and higher risk countries) the crude measure of setting floors globally will not lead to increased comparability. The higher the floors are set, the larger this problem becomes.

The focus of reducing risk variability should not be on equalizing risk weights but on reflecting risk in a similar manner. So higher risks should get higher risk weights and vice versa.

We kindly refer to chapter 3.1. “The Capital Floor” were we stated that we see no need for a Capital (output) Floor on top of the Input Floors, and the non-risk-sensitive Leverage Ratio.

Also, related to the Input Floors we kindly refer to chapter 3.2 “Parameter floors (PD, LGD and EAD)” were we stated that Input Floors should not only floor incorrect (too low) PD, LGD and EAD values. Input Floors should only be activated if the model performs under certain minimum requirements.

3.4.5. Retail Mortgages

32. State guaranteed mortgage structures.

In the Netherlands approximately 25% of all residential mortgages benefit from a National Guarantee Scheme (Nationale Hypotheek Garantie / NHG), in which the counter guarantee from the Dutch Central Government reduces the LGD values considerably. Mortgages with NHG has 70% lower losses than comparable mortgages without NHG. Other countries may have other guarantee arrangements. In the current proposal no specific mention was made with respect to governmental guarantees. Given this assumption, the proposed 10% LGD floor will significantly increase the capital requirements for these mortgages. Next to the government guarantee schemes, there are various types of commercial insurance in the Netherlands, where the risks are also reduced considerably. We kindly ask the BCBS to maintain the current regulatory treatment for these kinds of structures.

3.4.6. Counterparty Credit Risk

33. Credit Valuation Adjustment (CVA).

The Basel Committee decided to remove the option for IMA-CVA from the proposed CVA risk framework. The Committee provided two reasons: the significantly reduced CVA positions due to central clearing and margining non-centrally cleared trades on one hand and the complexity on the other hand. We are of the opinion that an advanced framework for CVA is still appropriate. The main CVA positions are coming from positions against corporates as these are usually not covered by CSAs. This will not change as the new requirements w.r.t. clearing and margining only apply to FIs and very large corporates. On the complexity we want to note that the accounting rules still require complex models for CVA and that for the trading book Basel already decided to allow a similar internal model for market risk. Therefore the additional effort to implement an IMA-CVA model will be limited for most of the relevant banks and should therefore not be impeded.

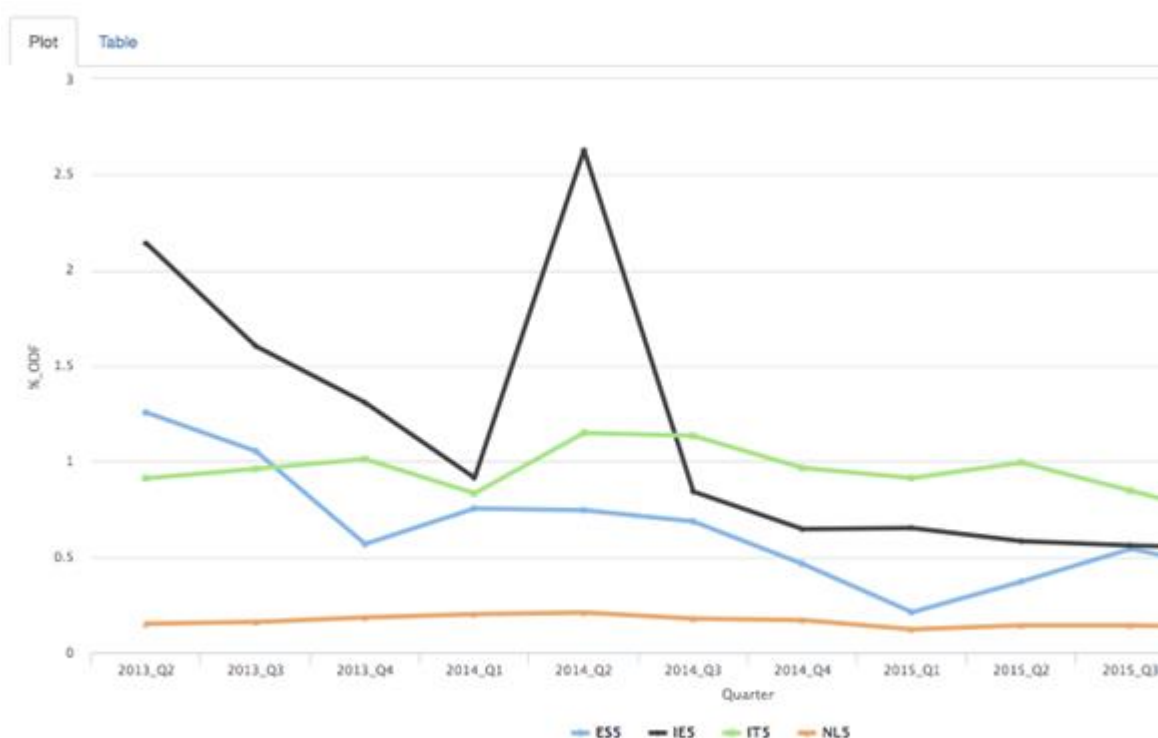
The announcement of BCBS to eliminate the Internal Model Approach for CVA (IMA-CVA) came as a surprise and we find this disappointing. Especially the decision not to collect any IMA-CVA data for the latest QIS. Such a data collection could have assisted in calibrating the different risk weights for the Standardized and Basic Approaches. The review of the CVA risk framework should not only consider simplification and standardization, but should also aim to capture an appropriate level of risk sensitivity.

Therefore our opinion is that especially with the decision to eliminate the ability of banks to use internal models for CVA risk (IMA-CVA), it is crucial to calibrate the CVA capital framework as good as possible to have an appropriate reflection of the economic risks.

Annex 1:

34. An example: residential mortgages: a floor will reduce the risk sensitivity and reduce comparability.

The A-IRB models are calibrated based on the portfolio characteristics and proven track records within the institutions. Under SA these portfolio characteristics are not included in the risk weight determination. Instead, for residential mortgages, a global risk driver (LTV) is used, which assumes that there are no differences between local markets or the acceptance criteria and risk management practices at institutions. As an example, graph 3 shows the observed default frequencies of mortgage portfolios per country. The data comes from the European Data warehouse, which is an open database. It concerns mortgage loans that are part of securitisations.



Graph 3, observed default frequencies (ODF) for securitized residential mortgage portfolios per country. Source: European data warehouse. Empowered by: www.os-is.com. ESS = Spain; IES = Ireland; ITS = Italy; NLS = the Netherlands. The “5” represents the fifth LTV bucket, being LTVs from 90% to 100%.

The graph shows the observed default frequencies for the LTV bucket 90% to 100%. The picture is comparable for the other LTV buckets. Per LTV bucket the actual losses, are very different per country, even within Europe. The (revised) SA is based on a single risk driver (LTV) and is not able to capture these difference in actual risks. When looking at A-IRB models often many additional risk drivers are included and often the models are built along the lines of the national border. Within many European banks the A-IRB risk weights are well below the SA risk weights for residential mortgages.

Input floors that are set globally, could override the A-IRB PD and LGD values, even in cases

were the performance of the models is very good. Hence, input floors should have a link to the performance of the models.

With respect to output floors (Capital Floor): if the A-IRB models perform well, there is no reason to floor these A-IRB based risk weights. If these risk weights will be floored, it will weaken the relation between risk and capital, which in the end will have negative consequences.