EAPB position paper on the Basel Committee for Banking Supervision Consultation Paper "Revisions to the Standardised Approach for Credit Risk" (BCBS 307)

27 March 2015

About EAPB

The European Association of Public Banks (EAPB) represents the interests of 32 public banks, funding agencies and associations of public banks throughout Europe, which together represent some 93 public financial institutions. The latter have a combined balance sheet total of about EUR 3,500 billion and represent about 190,000 employees, i.e. covering a European market share of approximately 15%.

The EAPB welcomes the initiative of the Basel Committee for Banking Supervision (BCBS) to revise the standardised approach for credit risk (CRSA) and to devise it so that it is more risk sensitive than the previous CRSA, whilst remaining simple to apply. As the changes are of a fundamental nature, we are thankful that the proposals are to be assessed by a comprehensive assessment and impact study.

General Remarks

In our view, a total renunciation of external ratings in the CRSA goes too far. As a result of the financial and state debt crisis, there was a political demand to reduce the dependence of external ratings in the regulatory framework. Nonetheless, in our opinion, banishing external ratings completely was never subject to negotiation and does not make any sense for that matter. Moreover, ever since the global financial crisis, external credit rating agencies (CRAs) improved their processes. The regulations around them were strengthened in the areas of independence and management of conflict of interest, transparency of rating disclosures, quality of rating processes, treatment of confidential information and internal controls and CRA accountability (e.g. EU Commission Regulations on CRAs in the European context). The parameters proposed in the consultation paper can only come remotely close to providing the same information as contained in external ratings from recognised rating agencies. In this respect, we strongly recommend, at least for the categories of banks and corporates, to continue to rely on external ratings. Only when there is no external rating available or no rating agency has been appointed, should the determination of the risk weight be based on new, easily identifiable parameters.

We have the impression that the goals originally set by the committee, to maintain the capital requirements stable with regard to the current CRSA, have been achieved only partially. The capital requirements as a whole, especially for banks and corporates as well as for real estate secured loans, appear to be clearly rising, so that it is not merely a matter of a

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shift of capital requirements in the individual asset classes. Particular consideration should here be given to the fact that an actual increase in capital requirements for all institutions ensues from the introduction of the capital conservation buffer. This raises the basic question about the need for adaptation when risks are weighted. In this context, we believe that with the revision to the CRSA, exposures to the least risky banks such as public banks would receive a higher risk weight than under the existing approach. Therefore, we are concerned that for the least risky assets, capital requirements would not be commensurate with underlying risk, but result in too high risk weights.

Furthermore, care must be taken since changes in the CRSA also have effect on other regulatory initiatives. For instance, the total loss absorbency capacity (TLAC) requirements are calibrated on the basis of the leverage ratio and the risk-weighted assets (RWAs). An increase in capital requirements in the CRSA could lead to an overall further rise in capital requirements if the calibration of TLAC remains unchanged. Moreover, the procyclicality of capital requirements is increased by the proposed changes, since a deterioration of the economic situation may impair risk drivers to a greater extent than external credit ratings used hitherto as external ratings are generally assigned on a "through-the-cycle" basis. This applies once again for both, the CRSA- as well as the IRB-banks due to the capital floor. The use of the common equity tier 1 ratio (CET1) could here trigger further "turbulence" for capital requirements because of the ratio's link to risk-weighted assets. In any case, the determination of the risk weight on the basis of two factors in general means clearly greater volatility. This complicates matters for the planning in the institutions required by supervisory authorities, and entails the risk of a long-term destabilisation of the financial system precisely in sensitive and essential areas of capital adequacy.

Additionally, we question why the BCBS might consider it as counterintuitive that exposures to systemically important banks, subject to higher capital requirements, would receive a lower risk weight under the proposed method. In our view, it would seem intuitive that a bank with more loss absorbing capital ceteris paribus would face a lower risk of failure, irrespective of whether the bank held such capital for regulatory or other reasons.

It should be also borne in mind that the committee's proposals would lead to a considerable increase of administrative burden in institutions having to deal with the processing of input information. This includes the constant tracking of required data on banks and corporates causing inordinately rising costs. If information is not available, a weighted risk of 300% is foreseen, which means at least triple the current capital requirements. This is disproportionate in our view. Furthermore, the IT capacities of the institutions have to be expanded considerably, which will also cause additional costs.

Bank Exposures

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As mentioned under the general remarks, external ratings should in essence continue to be used, given their availability and their assignment by an accepted CRA. Only when this is not the case, the proposed risk drivers or the central government risk weight based method should be relied upon. We are therefore pleading for maintaining the current option of determining the risk weight for institutions from the rating of the central government of the country in which they are domiciled.

A fundamental point of criticism to be levelled at the calculation of the risk weighting as a combination of the CET1 ratio and net non-performing assets ratio (NPA) is that these figures are not comparable due to national variations in their interpretation. In this context, serious discrepancies occur within the EU and this effect is even more amplified on a global scale. For example, despite of comparable credit risk, different accounting frameworks such as HGB, IFRS, GAAP lead to different amounts of value adjustments which consequently results in different net NPA ratios. Consequently, a common level playing field recedes further in the distance. Difficulties may arise when weighting risks for banks, if the CET1 ratio and the NPA ratio are not available. Nonetheless, in such cases the use of external ratings for credit institutions should still be authorised. A flat risk weighing of 100% would also be conceivable as an alternative. Another possibility would be using a flat-rate risk weighting in addition to a surcharge based on a country rating.

Additionally, we consider the proposal to use a risk weighing of 300% as extremely critical, especially if a national minimum prudential standard is not adhered to. This will lead to a worsening of the creditor’s position in the short term, which is not adequate, since the latter should not be held liable for shortcomings of third parties. Here, an appropriate period should be granted to the creditors, in which certain positions can be rejected.

It is moreover unclear how the concept of minimum prudential standards is defined and who in particular is to provide this information for the credit institution. We therefore ask for clarification in this point. Owing to the many possibilities of a national arrangement of capital buffers, reaching compliance with all minimum prudential standards will be hardly achievable, in particular in view of the international business of credit institutions.

On the basis of the aforementioned aspects, significant effects ensue on the lending business of development banks, because their loans are not granted in a direct customer relationship, but under the house bank principle. For these sub-loans qualified as institutional claims, considerable increases in capital requirements may occur as a consequence to the proposed risk drivers and the thereby resulting risk weights. The financing of business sectors in need of support (e.g. start-ups, housing construction, renewable energy) would thus become more expensive and the intention of supporting such sectors would be reduced to absurdity due to supervisory principles.

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In our view, the NPA is not suitable as a risk indicator. A reasonable determination is not possible owing to the lack of an internationally uniform definition of default. Moreover, we believe that no valid conclusion about the quality of a bank's assets can be drawn on the basis of this figure, since the degree of collateralisation of defaulted exposures is not taken into account. Hence, we think that the NPA is not a suitable risk indicator, as the default volume resulting from that indicator is clearly exaggerated. Apart from that, the structure of the liabilities must also be taken into account for a useful assessment of the creditworthiness of a credit institution.

Corporate Exposures

As in the case of banks, external ratings should continue to be used for corporate exposures. For corporates without ratings, alternative figures should be applied. In this context, it is important to take account of different corporate business models, such as of other crucial features prevailing in corporates. However, the proposal does not differentiate between the various features and we doubt whether the proposed indicators are reasonable and whether they correctly reflect the underlying risk. Consequently, we recommend, examining the suitability of further indicators (cf. remarks below on questions 5-7) on the basis of a better database in connection with another quantitative impact study (QIS).

The balance sheet equity ratio of corporations using the IFRS system can hardly be compared with an unincorporated company pursuant to national accounting requirements. The attempt to offset this would in any event lead to a further complication of the CRSA in this segment, which should be absolutely avoided (cf. preliminary remarks). We consider the use of "revenue" as indicator very critically, since as explained above, smaller corporates are clearly disadvantaged. The matrix prefers larger corporates, while smaller corporates such as small and medium-sized enterprises (SMEs) with lower turnover are generally given higher risk weighting.

Moreover, we believe that a risk weighting of 300% for credits, for which no current annual accounts are available, is too high. In example, the leasing business with corporates is set up in the framework of the corporate credit process and implies a regular assessment of the balance sheets before concluding the leasing agreements with the lessees. The leasing companies involved in the determination of capital requirements on a consolidated basis, have no leverage in subsequent years to have the annual financial statements of the corporates disclosed. In many cases, this is not even enforceable due to the market competition with other leasing companies not subject to supervision. This becomes particularly problematic, if there are no legal disclosure requirements for the corporates. Ultimately, according to the proposal, lessees, from whom the leasing company has no up-to-date annual financial statements, would be given a risk weighting of 300%. This is not risk-adequate. We therefore propose that the higher risk weighting of 100% and the risk

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weighting calculated from the latest available annual financial statement, should serve as a basis, if no current annual financial statement is available.

At present, the general risk weighting of 100%, which is independent of a rating, is frequently applied, in particular for the financing of SMEs. The Basel Committee describes at the outset, that the revision of the CRSA should not lead to any increase in the equity strain. Nevertheless, according to the tables, on the example of small corporates (turnover of less than €5 million), the factors are extended from 100% to 110% or 130% – we believe that this is not consistent and therefore think that a lower risk weighting below 100% should be provided.

The calibration of the risk weighting shows that large corporates are placed in a better position than smaller ones. Admittedly, on average, large corporates default more seldom than smaller corporates. This however is generally attributable to the fact that large corporates operate on a broader refinancing basis than smaller corporates, e.g. through direct access to capital markets. Against this background, the procurement of equity capital or equity-type capital (e.g. mezzanine capital) is clearly facilitated for large corporates, whereas small and medium-sized enterprises depend primarily on the direct contribution from a very restricted circle of owners. Consequently, the size of the company has a rather limited explanatory force – notwithstanding the statistically significant connection between size and default rate. Thus, the analysis of the Basel Committee should also take due account of the individual loan volumes of small and medium-sized enterprises and, in the sense of a diversification, the possible default amount. For the crediting of large corporates, it appears more likely that large loan volumes are issued, while decidedly smaller amounts are involved in the financing of small and medium-sized enterprises. As such, it is economically not reasonable that a large company with only a small equity ratio of e.g. 0.1% gets a risk weighting of 90%, while e.g. a company with €50 million in turnover should get a risk weighting of 120% for an equity ratio of 19%.

We therefore consider it as necessary and appropriate to determine the risk weighting for large corporates and SMEs separately and to carry out a separate calibration to that end. The proposed preferential treatment for start-ups (use of a risk weighting of 110% in the year of establishment) should not be applied exclusively on the basis of the availability of balance sheet data. Rather, the privileged risk weighting should be connected to the existence of a start-up. Owing to the high initial investments and losses of these corporates, the aforementioned risk drivers based on profitability do not make sense. The BCBS recognises the need for support of start ups in this context. Therefore, against the background of the average time it takes to break even, the privileged risk weighing should be applied for up to five years after the establishment of the company.

Specialised Lending

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In general, an exception should be made for real estate financing from the specialised lending category, if it can be proven with a hard test, that a highly developed real estate market has existed for a long time. Furthermore, the default dependency should be included as additional characteristic for specialised lending exposures. For real estate this means that the value of a property depends on the creditworthiness of the debtor. We reject including e.g. pure infrastructure financing schemes in the special lending category. In this context, eligibility for support devised by the state for such projects (public-private partnerships) should not be thwarted by supervisory regulations.

Subordinated Debt and Equity

The goal of methodically aligning the IRB approaches (IRBA) and the new CRSA is not achieved with risk weighting of 300% and 400% in the new CRSA, since lower risk weighting rates of 190%, 290% and 370% apply in the simple weighting approach of the IRBA. In the absence of a consistent argumentation, it is not practicable to give risk weighting of 300% and 400% for investments. Risk weighting of 400% for participating interests, which are not traded on the stock exchange, is clearly too high. This means that a rapid rise from the current 100% to 400% is not appropriate. This applies also for subordinated loans with a risk weighting of 250%. The conclusion of a subordination agreement does not increase the likelihood of default by the contracting parties per se. Only a possible loss would be higher. Should subordinated claims no longer be recoverable, an individual value adjustment would additionally be needed. For this reason, a risk weighting of 250% represents a disproportionately high capital requirement, all the more so as the equity capital has already been reduced by possible value adjustments. We are pleading for maintaining the risk weighing for subordinated claims dependent on the respective asset class, by analogy with assets without subordination agreement. The proposed preferential treatment of support for start-ups in the corporate class (risk weighting of 100%) should be extended to the risk position stemming from subordinated loans and shareholding interests. In connection with the crediting of start ups, the financing consists in most cases of venture capital (financing with postponement of priority, equity assistance loans). As such, in addition to the possibility of the preferential treatment for the corresponding risk positions, we call for a period of application of the lower risk weighing for up to five years after the establishment of the company on the grounds of the average time that start-ups need to break even.

Retail Exposures

With view to the clustering within that category, we reject a mandatory use of the granularity criterion (0.2% of the entire supervisory retail portfolio). It is precisely in smaller credit institutions with a small retail portfolio that a very low maximum credit amount would result because of the criterion and this would lead to considerable distortion of competition.

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Claims Secured by Mortgage

We consider the process of real estate credit splitting which was used hitherto in Europe as sufficient to reflect the situation appropriately. In real estate credit splitting, the overall credit is split into a secured part and an unsecured part, which can solve the problem described at the outset. As a matter of fact, the real estate credit splitting leads automatically to a situation where the average risk weighing of the overall claim increases, the smaller the share of the real estate credit with a privileged risk weighing of 35%/50% (e.g. loan-to-value ≤ 80%) is in the overall credit. Furthermore, section 72 of the Basel II Framework does not exclude a split. A definition of 6 different loan-to-value buckets (LTV) is therefore unnecessary.

Commercial Real Estate

Based on the two proposals from the consultation paper, option A (section 44) seems to us as the more useful one because it contains in footnote 59 the exception for highly developed real estate markets that have existed for a long time. This would imply that the previous regulations are maintained given that more specific conditions in the application are met.

This should be combined with the tables from section 46 on option B. In other words, if the hard test was positive, a risk weighting of 50% would be applied, independently of the respective LTV. If the hard test does not turn out positive or is not administered, the table with the risk weighting depending on the LTV should be applied.

The Basel Committee consultation paper should include a clarification stating that, as hitherto, it is still enough to provide cash flow and default dependency in order to prove that no specialised lending is concerned. This should be also valid for the individual case. In addition, it should be spelled out that the hard test continues to be sufficient as to prove cash flow independence.

Credit Conversion Factors

Overall, the amount of credit conversation factors (CCFs) seems to us as too high. This applies especially for unconditioned, immediately cancellable credit commitments against corporates, since these are closely monitored and since there can be no opposed consumer protection requirements. However, the CCF of 75% for not immediately cancellable credit commitments is also too high from our point of view. In addition, we must point out, that an increase in the CCFs has immediate effects on the amount of the leverage ratio. As a consequence, this “side effect” should be taken duly into account. We cannot understand CCFs of 10% for unconditioned, immediately cancellable credit commitments. In retail

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business, credit lines are monitored closely and deteriorations in the creditworthiness are detected in a timely manner and can result in the cancellation of credit lines. The consumer requirements mentioned by the Basel Committee do not exist in the corporate segments. However, the corporates are also monitored very closely, so that a credit line can be reduced immediately. We therefore see a risk weighting of 0% for unconditioned, immediately cancellable credit commitments as still appropriate.

Multilateral Development Banks Exposures

We consider it as important that multilateral development banks (MDBs) that are particularly protected by the state, continue to receive a risk weighting of 0%. We observe that the BCBS recognises that the business models, corporate governance structures and shareholder composition of MDBs are very specific and ill-suited to the proposed risk-weight treatment for bank exposures. BCBS notices that claims on MDBs which are treated as corporate exposures might be unduly punitive and therefore proposes to introduce a subcategory of "qualifying MDBs" that retains the current risk weights based on the MDB's external credit rating, provided that certain conditions are met. As many of the characteristics of MDBs are also shared by specialised public banks, we believe that a corporate treatment would be unduly punitive for such public banks. We would therefore suggest introducing a qualifying treatment, similar to the treatment of qualifying MDBs also for public banks. It does not appear to be sensible to have exposures to non-qualifying MDBs categorized as corporate exposures.

Credit Risk Reduction Techniques

Harmonisation of the credit risk reduction techniques between CRSA and IRBA, particularly with regard to the use of a capital floor, is essentially worth striving for. As an example, a recognition of the claims as credit risk mitigation could be also extended to CRSA users, as long as the qualitative and procedure requirements are upheld, in order to avoid an exaggeration of the risks of loss in the CRSA as compared to the IRBA.

Please do not hesitate to contact us in case of any questions. We remain at your disposition.

With kind regards,

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