

11 March 2016

EAPB position paper on the Basel Committee for Banking Supervision 2nd Consultative Document "Revisions to the Standardised Approach for credit risk"

1. General Remarks

The European Association of Public Banks (EAPB) welcomes the decision of the Basel Committee on Banking Supervision (BCBS) to launch a second round of consultation on the revision of the credit risk standardised approach (CRSA). In this context, EAPB supports the BCBS's proposal to reintroduce the use of external ratings for bank and corporate exposures and therefore to step back from its initial proposal which envisaged to completely refrain from the use of external ratings. This decision addresses the concerns that were raised by financial industry stakeholders in the first consultation on the revision to the CRSA and may at least ensure a risk-sensitive approach. Moreover, the retraction of the 300% risk weight in these exposure classes is also seen as a step in the right direction.

Considering the expected application of the CRSA as floor for capital requirements determined in accordance with the internal ratings-based approach (IRBA), the standardised approach should be developed in a manner ensuring the most risk-sensitive approach possible. The suitability of using a standardised approach as a floor for model-based capital requirements is closely linked with the risk intensity of the CRSA compared to IRBA. With this in mind, the decision by the BCBS to only use the loan-to-value (LTV) risk driver as a basis for differentiating the capital requirements in important asset classes such as real estate should be reconsidered. This would make the capital requirements less risk-sensitive compared to the proposals made in the first consultative document. Furthermore, this approach would reduce the comparability of capital requirements or financial resources, rather than increase it. There would be also the additional problem that different types of default risks would have identical risk weights applied to them which could create scope for arbitrage. However, a final assessment of the second consultative document on CRSA can only be made by taking into consideration the interaction between a revised CRSA and its implications for floors for IRBA modelling. The lack of comparability and the arbitrage opportunities linked to the new proposals on CRSA could become even more severe if a revised CRSA will not demonstrate sufficient risk differentiation (flat risk weights). That would imply that the standardised approach would remain in the outdated methodological set-up of the old CRSA which dates back as far as 1988 when Basel I was published.

In this second proposal on the CRSA the relations between simplicity and complexity or comparability and risk sensitivity do not appear to be sufficiently balanced which however

would be highly important in order to decrease administrative and organisational burden for public and promotional banks and in order to recognise the principle of proportionality.

EAPB considers as particularly critical that a drastic increase in capital requirements could come along with the second proposal on a revised CRSA as compared to the current CRSA. Even if the BCBS publication of a second consultative document on the CRSA was deemed as necessary and is viewed as positive, EAPB would like to point out under item 2. “Detailed Remarks” the potential disadvantages in this second proposal which result due to higher risk weights and additional burden for public and promotional banks. Moreover, the distinctive features of each country (e.g. regarding the real estate market) as well as the interests of public and promotional banks must be given greater consideration with the final aim of not increasing total capital requirements for these entities. In this context, EAPB welcomes that a Quantitative Impact Study (QIS) announced for the early 2016 and based on data collected up until 31 December 2015 will be performed in order to observe the impacts of the second round of proposals on the CRSA.

2. Detailed Remarks

Exposure to Banks

Due Diligence Requirements (Items 14–15)

The use of external ratings is supported, as this ensures an international level playing field concerning the amount of required capital. In the European Union, credit decisions are not made solely on the basis of external rating but also rely on risk assessment. Nevertheless, any due diligence process that might be carried out cannot consist of performing an individual assessment with an “internal credit analysis” for every single borrower. Instead, it should be possible to analyse at a consolidated level, e.g. for specific homogeneous groups of borrowers or for certain asset classes, whether or whether not the risk weight derived from the external rating is appropriate, whilst still considering the risk profile and the characteristics of the group of borrowers or asset class. Therefore, EAPB would appreciate further clarifications on this item in order to avoid an unduly burdening of public and promotional banks. Moreover, further clarification is needed on whether the requirement to perform the due diligence analysis “on a regular basis” can be understood in a manner that implies to carry out the analysis only at regular intervals, but not ad-hoc. Furthermore, the BCBS offers no guidance for cases in which a due diligence analysis cannot be performed which is why it would be assumed that the risk weight in this case is to be determined according to the external rating.

Should the BCBS still envisage implementing the due diligence process despite of the raised concerns, it is crucial that institutions are allowed to use their current internal assessments of pillar 2 for this purpose. This is the best practicable and reasonable approach for such a due diligence process because the assessment of pillar 2 is approved and regularly monitored by national supervisors. Otherwise, institutions would have to develop a second internal assessment process which would be economically and operationally inefficient and unreasonably burdensome. Furthermore, institutions would receive and have to explain different results from their two differing assessments. Therefore, the BCBS's revised proposal on CRSA should explicitly mention that the internal assessment of pillar 2 has to be used for the due diligence process.

Finally, the reliance on external ratings cannot be reduced if any foreseen due diligence process could only result in higher risk weights. The achievement of the Committee's aim is only possible if an optional due diligence process could also lead to a lower risk weight. In this event on the one hand the significance of external ratings could be reduced as external ratings could only provide an indication instead of setting a floor for risk weights. On the other hand, the possibility of lower risk weights could also form an incentive for institutions to evaluate a more detailed due diligence process.

External Credit Risk Assessment Approach (ECRA, Item 17-18)

In order to use external ratings, it is necessary for the institution to first of all acquire an expensive licence. Even if this licence is already available, the borrower may potentially have been rated by another external agency. For such cases, the institution should not be forced to use the external rating but should have the possibility to use the standardised credit risk assessment approach (SCRA) as a back-up.

According to Item 17, the due diligence analysis cannot result in the application of lower risk weights than the risk weights derived from external ratings. The EAPB does not consider this requirement to be appropriate since the institutions must provide evidence of the adequacy of their due diligence analysis (Item 15). Should it no longer be possible for the due diligence analysis to result in lower risk weights as opposed to external ratings, the entire due diligence would lose its credibility.

According to Item 18, the maturity differentiation should be determined based on the original maturity. However, EAPB believes that instead, it should be based on residual maturity because the maturity for short-term exposures to banks of up to three months is to be determined based on residual maturity in accordance with Article 120 (2) of the Capital Requirements Regulation (CRR). This is indeed the correct method as both, the external credit rating agencies and the credit institution, constantly monitor the credit ratings of banks. By doing so, the credit rating agencies and the banks comply with provisions laid down in the European Union Regulation on Credit Rating Agencies. In the case of different initial maturities the risk is still considered as comparable for two institutions having the

same credit rating, identical risk profile and same residual maturity, because the period in which risks could occur would be identical. Thus, it would not be reasonable to apply different risk weights for a comparable risk due to different initial maturities. On the contrary, using the initial maturity would lead to a double-accounting of the risk; once for the components of the maturity and once again for a possible worsening of the credit rating assessment, which is not an appropriate method.

In addition, EAPB does not believe that risk weights derived from the internal due diligence should only be higher than risk weights derived from external ratings since this could harm the value of the internal due diligence process and the added value of internal credit analysis. Due diligence should be able to result in the application of better risk weight levels where the results are appropriate to do so.

The BCBS's belief that banks' external ratings as used for regulatory capital purposes should exclude government support could be problematic from a practical perspective. Though rating agencies are aware of this issue in the context of other regulatory reform measures (including those pertaining to recovery and resolution) and in some cases have already removed government support from their ratings for many banks, EAPB believes that this point should be addressed primarily by the rating agencies in consultation with the appropriate authorities, as financial institutions need to be able to rely on ratings published by the agencies as they stand at the time of application of the CRSA framework. It will also be very difficult to implement such a proposal given that data is only partially available and the treatment of government support by the rating agencies is not homogeneous.

Standardised Credit Risk Approach (SCRA)

The classification into three proposed "grades" may come along with a considerable increase in risk weights and may be associated with additional time and effort as opposed to the status quo, due to the amount of information that needs to be collected. In addition, there might be discrepancies between risk assessments which are decisive for credit decisions and the grade classification as proposed by the BCBS that is relevant for the determination of capital requirements. In some cases, an unfavourable decision on capital requirements might lead to an unreasonable rejection of a loan. Thus, it should be further clarified what is subsumed by "published minimum regulatory requirements and buffers". It is currently assumed that this refers to the minimum standards which are applicable in terms of capital ratios and leverage or liquidity (Item 21, 24). Moreover, in order to avoid a significant increase of the global capital requirements, an additional bucket with a 20% risk weight could be introduced which however a clear definition of criteria along which counterparties would have to be allocated to the right bucket.

Furthermore, the BCBS notes in the consultative document that for unrated exposures of banks incorporated in jurisdictions that allow the use of external ratings for regulatory purposes (and for all exposures of banks incorporated in jurisdictions that do not allow the use of external ratings for regulatory purposes), a bank should as part of its due diligence

assessment be able to assess the credit risk of an exposure and classify the exposure under grading system A to C with the commensurate risk weighting applied. However, the EAPB believes that the criteria and triggers applied under CRSA for grades A to C are imprecise, not necessarily aligned to banks business models and would likely increase administrative efforts to document the due diligence undertaken and the results that lead to the assignment of the appropriate grade. Such an approach would be particularly burdensome in legislations with large populations of unrated banks. Under Basel II, these legislations generally apply the option to base the risk weight on the risk weight of the sovereign. In the EU, unrated banks still receive a risk weight which is based on the risk of the sovereign rather than requiring a more elaborate assessment. This appears to be a more appropriate solution for a standardised approach which should be simple to use.

Exposures to securities firms and other financial institutions

It should be made clear that these firms being subject to regulatory measures on a consolidated basis also fall into the bank exposure. This point is particularly relevant for specialised credit institutions without a deposit business such as it is the case for most promotional banks.

Exposures to corporates

General Corporate Exposures (Item 32–37)

According to Item 37, unrated exposures to small- and medium-sized enterprises (SMEs) in the corporates exposure class can be assigned a preferential risk weight of 85%. The EAPB welcomes the perception of the BCBS that such exposures imply lower risks than “normal” exposures to corporates. However, the EAPB believes that the reduction of risk weights is still not sufficient in particular if comparing the BCBS proposals with the respective regulations in place in the European Union. Thus, further harmonisation between the BCBS and the European Union legislation should be performed in order to not to overstate the risks of SMEs. Furthermore, two situations should be avoided. Firstly; a situation in which the credit default risk posed by small and medium-sized enterprises is represented at a significantly higher value than the actual risk and secondly; a situation in which the BCBS requirements in this context exceed the corresponding European Union provisions. The BCBS proposals should therefore be reviewed and reduced to a more realistic extent, so that the actual situation of the risk posed by SMEs can be adequately represented. In example, this could be achieved by allowing for risk sensitive rating tables for SMEs, based on ECAs rating or further risk drivers. Such an approach would reflect that SMEs have a lower risk correlation than large corporates and often benefit from collateral which is not recognised under the CRSA.

In addition, there should be a specific provision governing a change in credit rating for the corporate concerned and, as a result of this, there should also be a change of associated risk

weight. The EAPB believes that such events are still not being paid enough attention to and that, if not resolved, they could cause frictions in the practical implementation. This becomes particularly relevant in situations in which the credit rating of a corporate changes several times and the risk weight therefore has to be continuously adjusted accordingly.

Moreover, as to enhance comparability across jurisdictions for investment grade counterparties, the BCBS could consider risk weights lower than 100%, e.g. 75% as applicable to BBB+ to BBB- counterparties.

Specialised Lending (Item 38-41)

Referring to Item 41, more differentiation should be allowed for in “project finance exposures” depending on whether the project would be in a “pre-operational phase” or “operational phase” as the “pre-operational phase” is associated with greater risk. Therefore, it is important to clarify when exactly the transition from the pre-operational to the operational phase takes place. It should not be left until the stage of when the project would be “completed and fully operational”, but rather fixed at an earlier time. In order to do this, the institutions could draw up their own internal risk-based guidelines to determine when the transition can be considered complete in order to guarantee a certain amount of flexibility when applying the regulation.

Real Estate Exposure Class

General Remarks

One central point of criticism concerns the proposed capital requirements for real estate credit, with particular reference to the proposed risk weights for the financing of commercial real estate. It is perceived as negative that a general risk weight of 35% would no longer be possible for residential real estate in the future. EAPB believes that this has not taken into account the different national characteristics on the real estate markets. The national differences must be given greater consideration. In particular, an escape clause should be insisted upon for countries whose real estate markets and credit approval guidelines warrant much lower risk weights. In order to avoid the resultant shortage of credit options, common sense must be applied by keeping the risk weights at their current levels. Otherwise, this would in turn have consequences for the entire economy.

LTV risk factor

It would be preferable to create a definition for the “prudent value” in Item 52, which would be identical for all countries. This should be done with greater precision as opposed to what has been the case in the past. Depending on the interpretation of prudent value, there would be considerable leeway on international level on how the BCBS provisions would have to be

applied. This would imply that comparable properties or real estate financing would have significantly different LTVs and therefore different capital requirements. On the contrary, properties or real estate financing which are not comparable could result in identical capital requirements which was certainly not the intention of the BCBS and implies a central drawback of the new CRSA proposal. Likewise, neither would it be reasonable to base the calculation of capital requirements on LTV when issuing loans, unless stated otherwise by national competent authorities. In order to ensure that countries with loan value regulations are not placed at a disadvantage, it should be made possible for such countries to have the option of choosing between loan value or market value.

The new proposals made by the BCBS state that the LTV should in the future serve to measure the risk for housing credit, provided that the relevant conditions are met. EAPB believes that this could render the calculation of relevant risk weights significantly more complex and time-consuming. According to this method, the risk weight for LTV values of up to 100% would be between 25% and 55%. However, for LTV values over 100%, the risk weight of the borrower would be used. If some of the qualitative requirements would not be fulfilled, then a risk weights increase varying between 120% and 150% could occur. Therefore, EAPB would suggest a reconsideration of the risk weights for real estate finance in order to avoid drastic risk weight increases. It is also unclear whether the LTV should be applied if a loan is granted for more than two properties, thus meaning that different LTVs apply for a single loan. EAPB would welcome if the BCBS could further elaborate in that.

Residential Real Estate

The risk weights for residential real estate exposures which are dependent on cash flow are stipulated in Item 56. Footnote 50 states that loans to associations or cooperatives of individuals are excluded from this treatment. This exception should be extended including also publicly operated housing associations. Public housing associations make a considerable contribution to the provision of rented housing. Raising the risk weight from its current value of 35% to the proposed value of at least 70% would fundamentally challenge the business ran by these associations.

Land acquisition, development and construction exposures (ADC, Item 61)

ADC loans are by definition loans used to finance acquisition of a site, development of a site or the construction phase. The BCBS proposes to continue applying a risk weight of 150% which is however punitively high. For real estate development financing, information is invariably requested regarding the number of properties that have already been sold. This means that before the building construction phase, the developer would have to demonstrate the marketability of the property by means of sales. Therefore, the assumption cannot be made that there is uncertainty about sales. Furthermore, the remaining loan amount is always under 100% both in the building permission stage as well as during the

construction phase. For the construction phase it is generally under 75%. With this in mind, the general uncertainty of the sale or cash flow may not be taken as a given and the risk weight of 150% should be lowered.

Add-on risk weight to certain exposures with currency mismatch

While EAPB acknowledges that an add-on is justified in the case of currency mismatches due to a higher default risk from the borrower if the borrower does not take out an adequate financial hedge (Item 62–63), the 50% add-on in accordance with Item 62 is nevertheless too high and should be reduced. In the corporate exposure class, which is predominantly made up of unrated exposures, this would lead to a risk weight of 150% for the corresponding exposures. Thus, exposures with a currency mismatch would be categorised in the same way as defaulted exposures which is hardly justifiable. Additional problems could arise if focusing on the income of a counterpart rather than on the characteristics of the transaction since this could imply that two transactions of the same kind would be treated differently. The justification of such an add-on is also debatable for counterparties with external ratings, which should, at least partly, be already included in the currency risk. Therefore, the EAPB would welcome if the BCBS could provide a clearer specification of the scope and the limits of the add-on risk.

Moreover, it remains unclear what to subsume under “hedged” exposure. Here, it is perceived that hedging can only relate to the client's default risk and does not relate to the foreign exchange (FX) risk borne by the bank and stemming from a FX credit. Since banks hold already additional capital for FX risks in the banking book, a double-accounting in this context should be avoided. Moreover, and derived from previous BCBS capital requirements on foreign currency risk – the FX add-on should not apply to closely correlated currencies. Due to the high-level of correlation between two currencies, the default risk of the borrower would not increase with currency mismatches. According to the current proposals from the BCBS, currency mismatches are to be determined based on the currency which forms the borrower's main source of income which however does not seem practical. It is thus suggested that the currency of the borrower's host country is used instead of the income currency.

Off-balance sheet items

EAPB welcomes the reduction of risk weights for credit conversion factors (CCF). Still, the proposed risk weights for CCF are perceived as too high. An increase in CCF has a negative effect on the willingness to approve credit or leads to tightened contractual conditions. In particular, the new BCBS proposals may introduce greater complexity in the calculation of the relevant credit conversion factors. Under Item 66, a credit conversion factor of 50% is applied for other off-balance sheet items. If the BCBS generally decides to introduce higher credit conversion factors, it should at least differentiate by the credit period. Furthermore,

EAPB would like to encourage the BCBS to further elaborate on the treatment of unconditionally cancellable commitments (UCC) under the CRSA. According to EAPB, UCC should be granted a 0% risk weight, given their importance for operational issues.

Defaulted Exposures

Valuation adjustment in the case of defaulted exposures should continue to result in a reduction of the risk weight (Item 77). A valuation adjustment normally already covers the expected loss incurred on the part of the IRB banks. For CRSA banks, the valuation adjustments are, in part, still considerably higher than for IRB banks, because the valuation adjustment frequently relates to the unsecured part of the exposure without any consideration being given to recoveries after default. In this respect, the uncertainty relates to the amount of the security which is recoverable. In case of a defaulted exposure, there is no longer any uncertainty regarding the probability of default and the uncertainty would only relate to the extent of the loss given default (LGD), the risk weight should continue to be 100% given a valuation adjustment of or above 20%. The procedure is justified since the valuation allowances created in the previous financial statements reduce the relevant exposures to which the risk weight is to be assigned. In the event of a valuation adjustment of 20%, the unexpected risk of loss is significantly reduced. A risk related to the amount of LGD only exists for that fraction of the exposure for which a valuation was not created. It should be clarified clear that defaulted exposures which are secured by residential property (Item 78) and which meet the minimum requirements in line with Item 50 (and therefore depend on cash flow) are always assigned a risk weight of 100%.

CRM techniques

In table 14 of Item 149, an additional column should be added for reduced haircuts for STC securitisations (simple, transparent and comparable). This is justified since it would considerably reduce structural risks and the risk of an inaccurate valuation. This is linked to the BCBS consultation (BCBS consultative document “Capital treatment for simple, transparent and comparable securitisations”) elaborating the reduction of capital requirements for STC securitisations.



3. About EAPB

The European Association of Public Banks (EAPB) represents the interests of 31 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%.