



BANKING STAKEHOLDER GROUP

CONSULTATION ON BCBS/D347 ON
“REVISIONS TO THE STANDARDISED APPROACH FOR CREDIT RISK”

General Comments and Specific Suggestions

BY THE EBA BANKING STAKEHOLDER GROUP

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The decision to submit this brief was in no way suggested or endorsed by the EBA: hence, the present document only reports the independent views of the BSG. While discussions with EBA Officers are gratefully acknowledged, the opinions expressed below were not influenced or inspired, neither formally nor informally, by the EBA.

Foreword

In this report, the BSG expresses its views on the second consultative document on the revision to the Standardised Approach for credit risk (“CP347”) that was released on the 10th of December 2015 by the Basel Committee on Banking Supervision (“BCBS”).

The BSG is a statutory advisory body of 30 members, appointed to represent in balanced proportions credit and investment institutions operating in the European Union, their employees’ representatives as well as consumers, users of financial services, academics and representatives of SMEs. The BSG aims to provide the European Banking Authority (EBA) with an organised stakeholder view towards initiatives of EU banking supervision and regulation. More information can be found at: <http://www.eba.europa.eu/about-us/organisation/banking-stakeholder-group>.

Whereas the BSG’s position papers mainly focus on draft technical standards and guidelines issued by the EBA, it may – and does – comment on all matters that can have a bearing on European banking regulation and supervision. Accordingly, at the BSG’s last meeting of 16th of February 2016 in London, it was agreed that a submission would be made to CP347. As indicated in the disclaimer above, such decision was in no way suggested or endorsed by the EBA.

In the remainder of this document, we first provide some general comments, followed by our responses to the specific items indicated in the BCBS’ consultative paper.

General Comments

Compared to the first consultative document on a revised standardised approach (“CP307”, released in December 2014), we consider that the second proposal includes a number of important improvements, like the reintroduction of external ratings as a risk assessment tool for exposures to banks and corporates. We believe that by allowing the use of external ratings, rather than relying solely on the “financial ratios’ approach”, simplicity and risk sensitivity are better balanced.

However, there is still a number of significant issues that, in our opinion, may be better addressed, in order to further increase the effectiveness of the BCBS’ proposals on a new standardised approach. Our key general suggestions are outlined below.

1. **The Basel committee is proposing an extended scope for the Standardized Approach for credit risks (SA).** In fact, the SA will not only be the capital adequacy method for banks not eligible for internal models, but will also serve a reference point for disclosure and for “capital floors” (risk-weight floors) to be imposed onto IRB banks. The latter use can lead to meaningful results only if there is a strong and unambiguous relationship between the new SA weights and the actual risk of the underlying exposures. This may prove hardly achievable as long as the revised SA is bound to be very simple and rests upon a highly standardized, one-size-fits-all approach.

Due to capital floors, the SA could indeed become the most relevant capital framework, even for IRB banks. For many IRB portfolios, this would result in a significant loss of risk sensitivity, meaning that large increases in capital requirements could emerge also for low-risk portfolios. In our view, this would have a seriously negative impact on risk allocation and systemic stability, as the lowest risks may be sold/shifted off balance, and the relatively higher risks (for which the SA may underestimate potential losses) would remain on the banks’ balance sheets.

2. **In our view, it is therefore important to improve the consistency and risk-sensitivity of IRB models, rather than imposing exogenous floors.** Our suggestion therefore is to improve IRB models and to make them more transparent. This can be achieved by enforcing consistent definitions of the key parameters and concepts, by reassessing risk-measurement methodologies challenging their underlying assumptions, and by promoting stricter data quality criteria in these models. While we believe that much can be learned from best practices, we would like to emphasise that differences in models (and risk weights) across banks should not *per se* be worrisome. Such differences may in fact reflect a variety of underlying risks, so that a rigid

harmonisation of models could prove a hazardous way to go. Indeed, the best approach for the efficient operation and stability of internal models is one in which a range of various outcomes is assessed, challenged and possibly accepted, instead of an exogenous threshold being made mandatory.

3. It is also paramount to **acknowledge risk-mitigating features**, e.g. by expanding eligible collaterals. Conversely, the emphasis on simplicity may prevent the new SA from taking appropriately into account the structure of different markets and the level/quality of collateral. If collateral is not adequately covered by the new SA, there is a risk that some business models – such as commodity finance – be unduly penalised. This would prove harmful to the goal of providing finance to the real economy.
4. In the same vein, we believe that differences in risk composition between jurisdictions and in application of credit conversion factors (CCFs) need to be better acknowledged. One area where national differences in Europe are very visible is the housing market. There are huge differences in tax, legislation, social security systems, maximum lending criteria and so on. This translates into large dissimilarities in mortgage products across countries. National differences affect the capacity to repay a mortgage and are an important determinant of the risk. We believe that **acting as if mortgage products and markets are the same everywhere invites problems**. Harmonisation is a desirable goal, but cannot be imposed. It will take time and will involve e.g. discussions about insolvency legislation, making it easier to unwind and recapture assets, and about a standardised definition of default.
5. **More detailed studies on the impact of the BCBS' proposals on the economy as a whole would also be desirable.** In this regard, the upcoming Basel QIS on the new SA will be an important step. The SA aims to change relative risk measures and the associated capital requirements, not to impose an overall increase of requirements. However, under the current proposals we anticipate a severe increase in capital requirements for several portfolios (including residential mortgages in some jurisdictions, some corporate asset classes and off-balance sheet instruments). It would therefore be prudent to avoid overreaction, and to watch closely the cumulative effect and the banks' ability to lend to all categories of borrowers.
6. Finally, we believe that sufficient time needs to be provided for implementation, taking into account the range of other reforms that banks are currently required to meet.

Specific comments

Residential real estate/ mortgages

We believe that the BCBS' proposals regarding real estate exposures fail to take into account important national differences. This may prove particularly harmful if the new SA is to serve a potential floor for the IRB approach, as the impact of such a floor would vary dramatically across countries. Risk weights should always be grounded on actual losses, to ensure that future risks are matched by adequate capitalisation levels. But historical losses vary significantly across different jurisdictions as illustrated in the graph below.

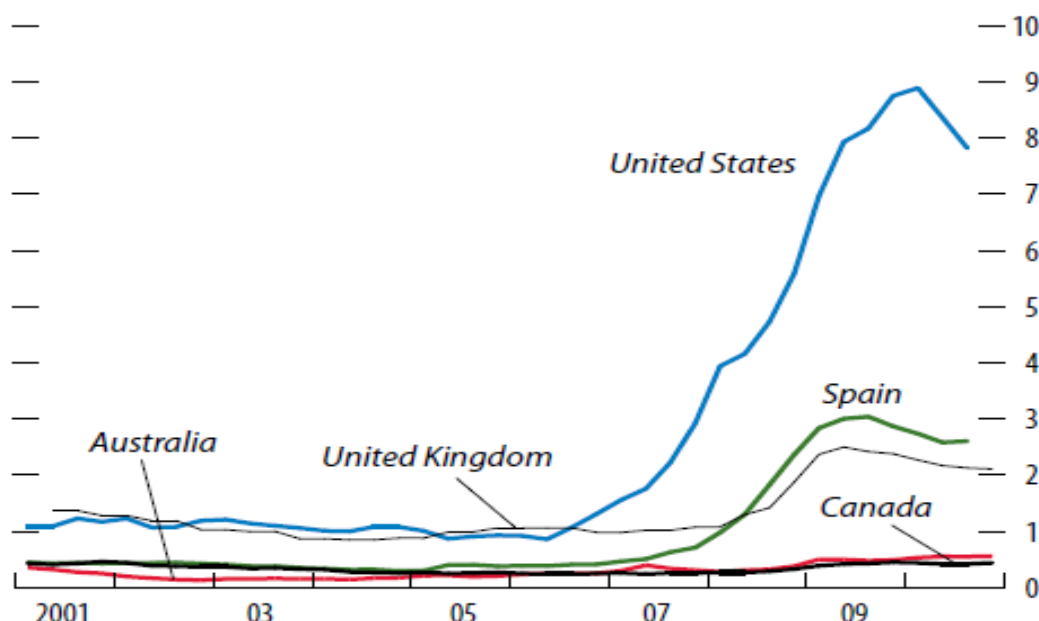


Figure 1 - Non-performing residential mortgage loans (in percentage of all outstanding loans) Source: Federal Reserve Bank of New York, Reserve Bank of Australia, Bank of Spain, UK Council of Mortgage Lenders, Lea. Nonperforming loans are loans that are more than 90 days in arrears. For Australia, Canada and the US, banks only.

Such differences are striking and it is hard to believe that they are simply due to differences in the loan-to-value ratios (LTV) across countries, or by different stages of the macroeconomic cycle. Most likely, they reflect other factors, such as local practices and local legislation, which would be overlooked by the new SA approach.

Hence, LTV alone is not a good measure of risk. In addition, some of the rules on LTV calculation and collateral recognition may prove unsatisfactory and/or have asymmetric effects in individual jurisdictions. We list some examples below.

- The BCBS' proposal is currently based on LTV at origination. We suggest that annual adjustments should be allowed, to reflect the actual underlying risk and sound risk management practices. Using LTV at origination incentivises a client to move to another lender, as the latter could charge a lower rate due to a lower LTV (due to a decrease in residual debt and/or to a rise in the value of the real estate collateral). To account for the latter factor, it should be considered whether an adjustment for inflation (or the house price index) should be allowed, to periodically update the value of the collateral.
- Even if a periodic adjustment of LTV were allowed, this could prove unfeasible if the residual debt is not being amortised: this is the case for jurisdictions where cash is instead invested in savings or pension plans linked to the mortgage, that are bound to be used upon maturity to pay back the principal¹. Such schemes, which are often motivated by national tax rules, may result in a discrimination, as loans would be classified as high risk (due to a high LTV) throughout their contractual life, while the actual risk exposure would gradually decrease over time due to the accumulated savings deposits.
- The current proposal does not permit the “tranching” (“splitting”) of a loan into different LTV tranches (each one to be weighted in line with its own risk weight). However, such **tranching should be seen positively, as it better reflects the underlying risk**. Furthermore, tranching would mitigate the cliff effect that originates from the proposed LTV buckets. Under the current proposal, if the LTV increases slightly and the loan moves to the next LTV bucket, then the risk weight could increase by 10%; if, instead, the loan is split into multiple tranches, the risk weight would increase gradually, in line with the underlying risk.

Aside from the treatment of LTV, **other significant factors are neglected by the BCBS' proposal**. This includes e.g. the borrower's legal liability for the remaining debt once the collateral is sold (“with” or “without recourse”), or the existence of special guarantees and insurances, possibly with some kind of government backing.

Furthermore, the current proposal fails to address the fact that there is **a variety of different business models for home loans**, each one with its own strengths and weaknesses. For the sake of simplicity, one could focus on two extreme models, i.e., the Anglo-Saxon approach (based on loan-to-value and floating rates) and the French/Japanese approach (based on loan-to-income and fixed rates). The latter is based on the following key features:

¹ Another loan scheme that deserves special care is the case of “bullet” mortgages (where the whole principal of a large portion of it is paid back upon maturity). Indeed, it can be argued that such mortgages should be weighted as residential real estate where the repayment is not materially dependent on cash flows generated by property, in line with the economic motivation underlying this type of residential real estate loans.

- As the rate is fixed, the amounts required to pay back the loan are known in advance. Accordingly, the customer is not exposed to the risk that fluctuations in market rates affect his/her monthly payments. More precisely, while being hedged against market rate increases, the customer may still benefit from drops in lending rates, by renegotiating the loan (usually with a low penalty or no penalty at all). This mechanism improves the customer's creditworthiness, as it makes easier for him/her to meet his/her obligations. Within this business model, customers are sometimes given the choice to pay a floating rate, subject to a cap or a collar. However, such an alternative is rarely used: in 2014, fixed rate loans accounted for 92.0% of all new home loans issued in France².
- Banks expecting a string of fixed rate payments from customers (subject to renegotiation risk in case market rates drop) have usually developed a set of sophisticated ALM models to monitor the underlying interest rate risks.
- The decision to lend is based on the customer's expected ability to repay the loan. E.g., monthly payments cannot exceed 30% of the customer's income after tax. Hence, the focus lies primarily on the client's capacity to repay the loan (PD, probability of default), rather than on the value of the real estate covered by the mortgage (LGD, loss given default).
- Accordingly, loan-to-value considerations mostly come into play when the bank must decide the initial size of the loan.

Thanks to these characteristics (as well as to compulsory death and disability insurances that generally assist the loan), this model generates very low default rates. E.g., the gross non-performing loan (NPL) ratio for housing loans in France was between 0.89% and 1.45% in 2001–2013.

The strengths of such business model (and its positive social implications) should be adequately recognised in the new standardised approach, unless one wants it to be weakened by regulation, *vis à vis* alternative models (focusing on the underlying assets, rather than on the borrowers' creditworthiness), which have proved detrimental to financial stability during the subprime crisis. Unless such concerns are met, the new regulatory treatment of real estate financing may prompt banks to shift towards the Anglo-Saxon model, leading to a less diversified and less resilient banking system. Additionally, lenders following the French model would be put at a disadvantage by the current proposal, as their stock of seasoned loans amortises very slowly, leading to high risk-weighted assets that would hardly reflect the actual risk of the underlying exposures.

² Source: Autorité de contrôle prudentiel et de résolution, "Housing finance in France in 2014", Paris, 2015 (available on https://acpr.banque-france.fr/fileadmin/user_upload/acpr/publications/analyses-syntheses/20150720_AS50_EN_Housing_Finance_2014.pdf).

Indeed, risk-weights' calibrations based on the Anglo-Saxon approach may prove inappropriate for the French model for two reasons: they may refer to customers with a comparatively higher risk profile and may reflect risks associated with a possible increase in floating rates, which however would not affect fixed-rate mortgages. At the very least, risk weights should be amended, for fixed-rate loans, by removing the credit risk due to possible misalignments between the customer's earning capacity and the payments on the loan. To appreciate the risk differential between fixed-rate and floating-rate exposures, it may be useful to recall that the EAD generated by a 20-year swap is around 20% of the swap's principal: accordingly, one may argue that the risk weight associated with a fixed-rate loan should be significantly lower than the one associated with a floating-rate one³.

To achieve a regulatory framework that is flexible enough to accommodate for different business models, the BCBS may follow a two-tier approach consistent with the one announced for banks and corporates. Similar to what happens now with external ratings, individual jurisdictions may be allowed to choose whether or not they wish to recognise LTV as the key risk factor for home loans. In case they do not, the use of different weights may be allowed, based on strict and uniform valuation criteria.

Credit Conversion Factors

The consultative document proposes a significant increase in capital requirements against certain off-balance sheet ("OBS") commitments, which may have an adverse impact on lending. This is the case for unconditionally cancellable commitments ("UCC"), where the contemplated removal of the 0% credit conversion factor ("CCF") may prove unduly punitive, and would not provide an accurate picture of the underlying risks. Additionally, the proposed CCF of 50-75% for UCC other than retail is not supported by adequate empirical evidence, and there is a concrete risk that it may be overly conservative, as it does not reflect the actual usage ratios of such credit lines.

It is worth emphasising that **excessive CCFs would provide an incentive to banks to cut on unused facilities, increasing liquidity risk for borrowers and market volatility**, with a negative impact on the real economy. Expected usage ratios and other CCFs should be better calibrated, taking into account one or more segmentation criteria in order to better reflect how different OBS items behave in practice. This could include a rigorous definition of UCCs and a study of actual EADs for OBS exposures (rather than IRB estimates, which may be subject to different modelling assumptions or supervisory practices). Differences across jurisdictions, e.g. due to national accounting or business practices, should also be taken into account.

³ Such a line of reasoning would be consistent with the one underlying add-ons for loan denominated in currencies other than that of the client's income.

Corporates

Under the new SA, corporate exposures will be split into specialized lending, exposures secured by real estate and other corporate exposures. Most of the banking sector's corporate exposures will fall into the last two categories.

As concerns exposures secured by real estate, LTVs based on property values at loan origination will be used, leading to drawbacks that are similar to those described above for residential real estate. In fact, the proposed methodology is bound to overlook the risk effects of LTV changes over time, as well as of different valuation practices across jurisdictions.

When it comes to other corporate exposures, the Basel Committee has chosen to retain external ratings, when available, as an anchor for risk weights. This seems an adequate approach to building a benchmark that is to be used globally, since agency ratings account for all relevant risk factors, including country-specific ones.

However, we believe that **a 100% risk weight for exposures to BBB-rated corporates may prove too high and deserves further analysis.** A risk weight for BBB-rated corporates that is twice the one for A-rated ones (and equal to that for BB-rated corporates) is not in line with the underlying risk profiles. BBB-rated exposures, unlike BB ones, are investment grade exposures and should be treated differently (and more similar to single As). **Our view is that the dividing line in terms of credit quality should be drawn between investment grade and non-investment grade, e.g. between BBB and BB.** Furthermore, a 100% risk-weight for BBB-rated exposures to large corporates may be at odds with the 85% risk weight for exposures to unrated exposures to SMEs. **To achieve a risk-weighting scheme that is consistent with the underlying risk, a 75% risk weight for BBB-rated corporate exposures should be considered** (although an analysis of empirical default rates associated with BBB-rated exposures may even justify a further reduction). This would be in line with the risk weight assigned to “investment grade” corporates in jurisdictions that do not allow the use of external ratings for regulatory purposes.

The proposed treatment would also give rise to an asymmetry concerning the way unrated exposures are treated in jurisdictions that allow or exclude the use of external ratings for regulatory purposes. In the latter case, they would receive a 75% risk weight whenever they qualify as “investment grade” exposures, while in the former case, they would get a 100% weight (85% if the borrower's annual turnover is below €50 million). Such an asymmetry should be carefully addressed.

More generally, further segmentation criteria could be explored, to differentiate risk weights for unrated exposures, including e.g. industry and country of operation, based on historical loss rates.

Exposures to banks

As concerns exposures to banks, it should be carefully considered whether covered bonds deserve a preferential treatment, in the form of lower risk weights. On one hand, they are assisted by specific collateral, leading to lower expected LGDs. On the other hand, market evidence from Sweden and other countries suggests that such bonds have performed well even under a stressed market scenario. Further, covered bonds provide an instrument for banks to fulfil their prudential liquidity requirements (“LCR”): accordingly, it is important that the costs associated with holding such liquidity reserves are not made unduly high by the capital requirements imposed under the SA.

In addition to that, the current proposals for unrated institutions are bound to lead to a significant increase in risk weights for banks headquartered in a highly rated country. In fact, while the CRR currently allows the use of risk weights that are based on country ratings (translating e.g. in a 20% risk weight for institutions domiciled in a country with a rating of at least AA–), that option will be removed under the new SA. Under the new approach, institutions will be split into three buckets, with the top-quality one getting a risk weight of 50%. This means that risk weights for high-quality banks operating in highly-rated countries will more than double, from 20% to 50%.

Specialised lending exposures

Under the new SA, specialised lending exposures would continue to be heavily penalised, compared to unsecured corporate exposures. Such treatment may prove overly conservative and not in line with the underlying risk. In fact:

- loss rates for specialised lending portfolios are often significantly lower than for corporate exposures;
- valuable assets and the related cash flows may provide an adequate source of repayment for banks.

Furthermore, specialised lending is key in supporting productive investment, object and infrastructure financing. A significant increase in the associated risk weights may have adverse effects on the price associated to these exposures (leading to higher lending rates), and on the other terms and conditions of the loans (e.g., through lower advance rates or shorter tenors). This would ultimately lead to a drop in this business, with a detrimental effect on the real economy. Such a risk can be averted by promoting a further differentiation of the risk weights associated with specialised lending, introducing one or more “safer” subcategories that may benefit from lower risk weights.

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