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EBF response to the BCBS consultation on Revisions to the Standardised Approach for Credit Risk

The EBF welcomes this opportunity to express the views of the EU banking industry in the international debate on the revision of the Standardised Approach for Credit Risk. European banks have shown continued commitment to the implementation of the Basel Committee standards which are applied in the whole EU banking sector including all types of banks.

The EBF response reflects the expertise and views of its member associations and banks. It includes indications as to the effects that the proposed changes could have in the banking business and its wider economic environment. Presumably, the parallel consultative paper on a Capital Floors Framework based on Standardised Approaches could enshrine much of the impact that the new standardised approach might bring to the banking system including on banks that use Basel compliant internal rating based (IRB) models for prudential purposes. The combined effect of both consultations should be carefully examined.

The EBF would like to engage in a constructive discussion on how to revise the standardised approach for credit risk. We think that an iterative process should be started by the Basel Committee and the industry in order to strike the right balance between the need to update the framework, the identification of parameters that are risk sensitive, simple and comparable and the implementation of forthcoming new requirements in practice.

Key points

- The EBF agrees that a balance should be struck between risk sensitiveness, simplicity and comparability.
- The Basel Committee should change what can be improved but, at the same time, the Basel Committee should not hesitate to keep the elements that work or where no improved treatment can be found in practice.
- The proposed Standardised Approach becomes a sort of risk model with a simple set of risk parameters. Therefore, the risk sensitiveness of the proposed risk parameters across asset classes should be tested and calibrated against empirical evidence.
- For that purpose, the timeframe and the depth of the quantitative impact study (QIS) and the ensuing calibration should be adequate. We believe that a second QIS subsequent to



the ongoing one will be necessary to properly calibrate this overhaul of the Standardised Approach.

- Certain changes proposed would give rise to further complexity that can represent a considerable implementation challenge especially for smaller banks. Risk drivers built upon concepts that do not have harmonised definitions across jurisdictions would hamper comparability. Data availability and need for IT investments are relevant factors to consider in the final design.
- Although the paper states that the objective is not to increase overall capital requirements, the values of the parameters and factors proposed clearly indicate a significant increase in capital.
- The concern that “*some risk weights no longer accurately reflect the risk of certain claims*” should not be biased by the current stage of the economic cycle. The Basel III framework includes a capital buffer to accommodate cyclical downturns.
- The new Standardised Approach should be a global standard with local calibration, allowing regulators to reflect specificities of the relevant market and the legal framework (e.g. mortgage), while nevertheless delivering principles for world-wide application, to be respected by all banks.
- If the Standardised Approach serves as a floor there will be a significant impact on internal ratings-based (IRB) approach portfolios which incentive should be maintained for the invaluable source of risk information they provide to banks, supervisors and policy makers at global and national level.
- External ratings represent a sound source of information for the risk appraisal of bank and corporate exposures. The poor performance and overreliance observed in the crisis were mostly associated with the ratings of certain securitisation instruments but were not apparent in the longstanding record of bank and corporate counterparty ratings. Moreover, external ratings are subject to the own assessment of institutions. Only where no external credit rating is available should the risk weight be based on the newly proposed parameters.
- The principle of proportionality should be applied in these standards. Small and medium-sized banks, non-internationally active, should have the option to use the current standardised approach. Otherwise, there will be a critical level playing field issue with jurisdictions that do not require to apply the Basel capital requirement framework to small domestic institutions.
- Changes to the standardised approach should not have a negative impact on banks’ ability to finance international trade, which directly feeds economic growth and employment. The treatment of officially supported Export Credits (ECAs) and short-term trade instruments should be appropriate to the risks.
- An adequate implementation timeline will be necessary for banks to collect data and build the calculation processes, especially in jurisdictions like the EU where all banks apply the Basel standards for capital requirements. We would like to reiterate that the EBF supports a constructive iterative discussion with the Committee complemented by an additional QIS in order to substantiate the new standardised approach calibration.

EXPOSURES TO BANKS

In our opinion, external ratings remain a suitable approach for bank exposures. Most banks have an external rating and rating agencies are more responsive in reflecting new developments than capital adequacy or asset quality ratios. Completely removing references to external credit ratings would be going too far in our view. In response to the financial and sovereign debt crises, a political call was made for reducing reliance on external credit ratings in standards, laws and regulations; yet totally eliminating references to external credit ratings was never contemplated in our opinion, nor does it make sense. A credit rating issued by a recognised credit rating agency contains far more information than the parameters proposed in the consultative document can come close to managing.

The problems with the use of credit ratings were associated mainly with the subprime crisis and, particularly, with the evaluation of certain securitisation instruments. But the use of external ratings for the risk appraisal of bank exposures has not suffered from those problems and could be maintained as a reference for banks that do not have IRB models in place.

We are therefore firmly in favour of continuing, under the standardised approach, to base applicable standard risk weight for exposures to banks and to corporates on external credit ratings. Only where no external credit rating is available should the risk weight be based on the newly proposed parameters.

The EBF is concerned that covered bonds are treated on par with other exposures to banks. If the covered bonds issued by a credit institution are governed by specific covered bond legislation that fulfils certain strictly defined criteria such covered bonds should have a preferential risk weight treatment. According to the current proposal banks do not benefit from the provided collateral behind the covered bonds.

We would urge the Committee to consider the case of covered bonds during the QIS and the calibration phases. Covered bonds represent the main source of balance sheet funding in Europe with roughly one fourth of the total residential real estate portfolio. The almost euro 1.7 billion of European covered bonds has a virtually clean record of credit losses even in the downturn of the crisis and in countries harshly hit by it. The recourse to the bank in addition to a preferential claim on the asset pool make covered bonds a distinct instrument characteristics and volume deserve a specific analysis.

Q1. What are respondents' views on the selection of the capital adequacy ratio? In particular, is the CET1 ratio superior to the Tier 1 ratio or the Leverage ratio? Do respondents agree that it is necessary to require calculations in accordance with Basel III in order to ensure a consistent implementation?

If the capital adequacy ratio is to be adopted, the BCBS capital adequacy ratios, preferably the total capital ratio, are arguably more appropriate than the leverage ratio. The underlying differences in the calculation of the leverage ratio make it less comparable.

However, the following operational complications will have to be addressed or accepted if the capital adequacy ratio is to be used:

- Certification: The capital adequacy ratio needs to be certified in order to be taken as official. Auditors can certify that a ratio has been calculated according to standards and rules in place, but the capital adequacy ratio is reviewed in the supervisory review and evaluation process (SREP) within the scope of pillar 2. Until this phase is completed, there is no certainty as to what is the capital ratio of an institution.
- Final ratio: Supervisors do not have a mandate to publish the results of the SREP, therefore the ultimate ratio coming out from SREP is not necessarily available for other banks.
- Further pro-cyclicality: Using directly the CET1 as risk weight driver would rapidly disseminate pro-cyclicality into the banking system.
- The CET1 is a changing figure due to the frequent changes to its regulatory definition. That volatility could hinder comparability.

The use of the leverage ratio to risk weight bank exposures also brings up potential problems:

- Leverage is meant to be a backstop measure but not a driver for risk and thus should not be used as a risk indicator for banks.
- The differences in the calculation of leverage would make it even more controversial as a global measure:
 - o Accounting standards allow for derivatives netting in some jurisdictions and not in others thus it represents a major problem of level playing field;
 - o The characteristics of the financial market differ across jurisdictions. For example, in the US the bulk of mortgage loans are transferred out of the regulated banking sector, therefore all these Basel Committee's proposals would not apply to a massive asset class like mortgage loans. At the same time, EU banks hold roughly the same volume of mortgage loans on their balance sheets making the whole EU banking sector appear as more leveraged. In these terms, we would like to draw the attention of the Committee to the fact that a fair comparison cannot be made and a level playing field cannot be achieved if leverage is used as a factor to determine the risk weight of bank exposures.

Q2. Do respondents believe the net NPA ratio is an effective measure for distinguishing a bank exposure's credit risk? What alternative asset quality measure, if any, should be considered by the Committee?

The NPA ratio is just one more measure of risk in the dashboard of a Risk Committee but its use as a single risk driver poses many problems, namely:

- The NPA ratio focuses only on default therefore it misses other important components of credit risk like the loss given default and the exposure at default.
- Accounting practices across countries and in particular the different definition of default would have a significant impact on the level playing field. In addition, it would imply a shift from the European Banking Authority's recent definition of non-performing exposure.

- The NPA ratio should be complemented with the value of collateral. The difference is illustrated in the following example:

		Bank A	Bank B
(1)	NPA Gross	100	100
(2)	NPA net of market value of collateral	100	50
(3)	NPA impairment	40	40
(4)	NPA net of impairment	60	60
(5)	NPA net of impairment and collateral	60	10
(6)	Total Loans (gross)	1.000	1.000
(4) / (6)	BIS Proposed net NPA ratio	6,0%	6,0%
(5) / (6)	Alternative net NPA ratio	6,0%	1,0%

- The risk weight of a bank is a very relevant factor. If it is explained only by way of the NPA, it will have repercussions in terms of risk management. For example, banks with best practice recovery processes show better performance in loss-given default but this would not count in the NPA ratio. Moreover, if a bank sells frequently its NPA, it may show a better ratio but poor performance in terms of loss given default because sales occur normally at a discount price versus the expected recovery outcome.
- The use of the NPA ratio would bring about pro-cyclicality to the system. If it becomes a regulatory risk factor, it would rapidly spread pro-cyclical behaviour throughout the whole banking sector.
- From the analysis of the risk-weight methodology defined in pages 8 and 9 of the consultative document, we presume that the risk weights disclosed (in page 31) were calibrated based on a 45% LGD and a PD computed as the ratio between the number of bank failures (in each CET1 and NPA combined intervals) and the total number of banks in the same CET1 and NPA combined interval. If this understanding is right, the following considerations should be observed:
 - A 45% LGD as a measure of a bank's loss under a default process seems very high regarding the money market operations performed between financial institutions in recent years. We would like to suggest that alternative risk sensitivity scenarios are performed to assess the suitability of a 45% LGD for bank exposures;
 - The way PD was computed raises some low population concerns regarding the potential lack of sufficient statistical information to compute such measure (limited number of banks that currently disclose CET1 and NPA ratios under Basel III framework and reached a default status). Alternative approaches should be assessed (e.g. PD associated to ECAI grades) to challenge the potential shortcomings of the approach considered by BCBS.

All in all, we think that the choice of NPA would result in a skewed measure of bank's riskiness.

Q3. Do respondents have views on the proposed treatment for short-term interbank claims?

We support a more favourable treatment for short-term exposures, which is consistent with the maturity adjustment in the IRB approach.

The risk weights for short-term interbank claims with an original maturity seem much too high to us. Moreover, we do not see original maturity, but residual maturity, as a suitable risk driver. A preferential treatment based on residual maturity seems a more appropriate treatment.

The floor risk weight of 30% means a 50% increase in the capital charge for short-term interbank claims. This is no mild adjustment and it does not appear to be justified based on empirical evidence.

Regarding the risk weight reduction approach (20% deduction from the long term risk weight) it does not reflect neither differentiate banks with different liquidity realities, which is an important risk driver for short-term operations.

In any case, the 20% risk weight which applies to short-term interbank claims with a duration of less than 3 months¹ should be maintained.

Q4. Do respondents have suggestions on how to address these concerns on the treatment of exposures to banks? In particular, do respondents have views on how to treat exposures to banks not subject to Basel III in a consistent and risk-sensitive manner?

Acknowledging the implementation challenges of Basel III and its CET1, we believe this still is the best framework to adopt for the purposes of measuring exposures to banks, given its strict definition of capital. It may be possible to agree a proxy conversion approach for non-internationally active banks not already subject to Basel III which could facilitate the implementation of this measure.

We think that the use of Basel III measures like CET1 for banks that are not subject to Basel III would be a contradiction. The same can be said of leverage because its definition for these purposes is different from the ordinary calculation of leverage. The only ratio that could make sense is the NPA but still affected by the level playing complications arising from dissimilar accounting frameworks and definitions of default across countries.

As an alternative, there exist approximate rating tools in the market that give an indication of risk based on quantitative factors where no full rating is available. It is not a full assessment but it could work in a consistent manner for all banks out of the Basel III scope.

In any case, we would urge the Committee to encourage the implementation of Basel III not only in internationally active banks but also in domestic banks as it has been the case in Europe from the onset of the Basel II standard.

¹ [BCBS 128 \(Basel II\)](#):

83. Commitments with an original maturity up to one year and commitments with an original maturity over one year will receive a CCF of 20% and 50%, respectively;

85. For short-term self-liquidating trade letters of credit arising from the movement of goods (e.g. documentary credits collateralised by the underlying shipment), a 20% CCF will be applied to both issuing and confirming banks.

A special consideration should be given to low-income countries, which do not apply Basel III and whose banks will hence not publish CET1 ratio or NPA in accordance with Basel III. In addition, these banks can be assumed to be unrated. While risk weights applying to these banks are today as a maximum 150% (point 63 of BCBS 128), it is now suggested to apply them a 300% risk weight which would be detrimental to the financing of International Trade (including lending under officially supported export credit insurances) whose importance was recognised by a BCBS working paper² which waived the Sovereign ceiling for these banks. The actual methodology should be maintained for banks established in countries which do not apply Basel III (including low income countries).

A 300% RW for claim to banks, in jurisdictions where Basel III is not required does not seem grounded on empirical evidence. EBF members argue that a more accurate risk weight would be no greater than 150%.

EXPOSURES TO CORPORATES

Like for exposures to banks, external ratings should continue to be used for exposures to corporates as well. Where companies have no credit rating, the proposed parameters could be used. However, we have doubts as to whether these are actually meaningful and capture the risk well. We therefore recommend examining the suitability of other potential parameters within the QIS.

There is a very important issue of scope. Loans to investment funds should not be treated as corporate exposures because the information required is not relevant for investment funds and these would therefore be applied indiscriminately a 300% risk weight with no regard to the true risk profile of these exposures which is dissimilar and considerably lower than the risk of corporate exposures. We propose an alternative approach based on the regulatory framework of investment funds, which constitutes an objective and transparent criteria across worldwide jurisdictions, where:

- Loans to Undertaking for Collective Investment in Transferable Securities (UCITS) and Mutual Funds, which are regulated by the highest standards in terms of investors' protection, should receive a risk weight of 100%;
- Loans to other regulated investment funds, such as alternative investment funds, should receive a risk weight 150%;
- Loans to non-regulated investment funds should receive a RW of 200%.

The assigned risk weights for corporate exposures appear to be overly conservative. We observe, for example, that the risk weight for highly-rated corporates (AA or higher) may be triple without empirical evidence based on past credit history.

Q5. Do respondents have views on the selection of risk drivers and their definition, in particular as regards leverage and the incorporation of off-balance sheet exposures within the ratio? Would other risk drivers better reflect the credit risk of corporate exposures?

² [BCBS WP 205 \(Is price stability enough?\)](#).

Revenue and leverage are seen as blunt instruments of risk measurement. Overemphasising turnover is not an appropriate measure of risk. There is a need to clarify the treatment for private companies with no obligation to publish accounts. If finally used, leverage should be adapted to industry type and type of lending. For example, a leverage ratio of 2 could be low risk in one industry sector but very high risk in another. For instance Insurance companies and Banks not subject to equivalent prudential standards and supervision will in all cases reach the maximum possible leverage. The appropriate leverage measures should be industry specific and the effects that they would have on borrowers from different sectors might give rise to further controversial arguments beyond the banking sector.

There is an issue of divergent accounting standards affecting the leverage figures across countries. For instance, in the EU IFRS is mandatory at group level for listed companies but local GAAP is applied to varying degrees by other companies which leads to measuring their assets at purchase price less accumulated depreciation. As a result these companies in general show artificially high leverage ratios in comparison to the companies applying IFRS. This means that the relationship between reported leverage and some kind of true leverage from an economical point of view could be quite stochastic.

We question whether the proposed division of risk weights for corporate exposures, with no possibility of regarding collateral, provides a reasonable risk measurement. Smaller companies constitute the bulk of standardised approach banks' corporate portfolio in many countries. Often equity in these smaller companies is underestimated because asset values are seldom valued at fair values.

We believe that an absolute measure as the revenue will create a big disadvantage for smaller firms and will not reflect the P&L generation capacity neither the balance sheet robustness of the firm as it does not include the cost side from the income statement neither promotes a relative measure to compare with the balance sheet dimension.

We would like to propose that the revenue risk driver should be replaced by a relative measure like the return on assets or the return on equity in order to reflect the profitability and not the magnitude of the firm.

Q6. Do respondents have views on the appropriateness of the proposed treatment, especially with regard to SMEs? And about the more lenient treatment for start-up companies?

We consider this approach is not supportive of SME financing. The proposed approach would make debt more expensive for SMEs which are a key part of the revival of economic growth both in the EU and beyond. We query why not to apply 100% risk weight for start-ups. After all, the 110% risk weight does not seem to be grounded on empirical data and will create a disadvantage for these firms via funding costs, extremely important in the beginning of their operation, when higher levels of investment are required, creating a burden on the instalments to be paid for the subsequent years.

It should be taken into account that numerous SME's such as micro firms are not required to publish financial statements and therefore, this lack of information would penalise them because the 300% risk weight will translate into tightened credit conditions and probably limit their access to finance.

Calibration of risk weights shows that small companies are put at a disadvantage compared to large ones. While back-testing might prove that large companies default less often than small ones, this could be due as a rule to the fact that large companies are, on average, in better financial shape than small ones. Besides there can be economies where SME loans have performed better than large corporate exposures. In other words, the univariate correlation between size and risk may stem from the fact that size is a summary of several other risk drivers, such as financial strength, profitability, access to funding sources, diversification, etc. When we move to a bi-variate world where a second risk driver is introduced, we should be careful to take into account for the correlation between risk drivers, or we risk to double count the effects: in the current BCBS proposal a smaller company may be penalised once because it is small and a second time because it has a worst leverage ratio. The size of a company thus tends to have little explanatory force, even if there is a statistically significant correlation between size and default rate. There is no economic justification for companies with a turnover of euro 50 million and an equity ratio of 19% being assigned a risk weight of 120% when a large company receives a risk weight of 90% no matter the level of its equity ratio. We therefore suggest adopting separate risk weights for large companies and SME's and calibrating these separately.

The risk should also be evaluated from an unexpected loss perspective, not only by considering expected losses. Expected losses are normally covered by the margin on credits, while the capital is supposed to cover unexpected losses. SME's might typically have higher expected losses than larger corporates, but that does not mean that capital needs are higher, especially not when considering a portfolio perspective where SME's provides for a much more granular portfolio and therefore less risk than larger corporates. This is well known in the Basel framework, where the Basel formula acknowledges this fact in through using lower correlation factors for smaller companies.

In order to ensure consistency and strengthen the link between the standardised approach and the internal ratings-based approach and mitigate the potential credit squeeze stemming from a lack of information faced by some SME's, we propose to:

- To split the corporate segment to introduce a special treatment for the SMEs in order to take account of their different nature. We propose to use the IRB definition of SME established in paragraph 273 of the Basel Accord³.
- Introduce a specific segmentation for SME's and more granular risk weight buckets in order to identify and differentiate between SME's risk profiles.
- Replace the revenue by a measure that could better represent the firm's profitability and health like the net profit margin (net income over revenue).

The separation of SME as a single asset class in the standardised approach would require the use of its own risk drivers. For that purpose we suggest:

- The use of behavioural credit information provided by *credit bureaux* should be allowed. These independent organisations play a fundamental role and have a good track record worldwide⁴. The information produced by these organisations is objective

³ Standard and Poor's and Moody's studies on Default and Recovery Rates in Project Finance have provided evidence that recoveries are higher in this industry than in the corporate unsecured lending activity.

⁴ Standard and Poor's and Moody's studies on Default and Recovery Rates in Project Finance have provided evidence that recoveries are higher in this industry than in the corporate unsecured lending activity.

and has empirically demonstrated to have a significant predictive power, such as the delay in payment of two instalments in the last 12 months.

- Behavioural drivers could be complemented by financial information. For instance, the financial expenses over total assets ratio has proven to be a good risk predictor.
- Where *credit bureaux* are not available, we suggest to use objective internal behavioural information because it is audited and supervised.
- In order to not penalise the creation of new SMEs on which neither behavioural information nor financial information would be available, the current treatment of 100% should be retained.

All in all, the risk drivers for SMEs should be calibrated in order to reflect the specificities of the sector and geography where these companies are located. These two components are critical for this segment that is highly influenced by the local business culture and the local rules.

Q7. Do respondents think that the risk sensitivity of the proposal can be further increased without introducing excessive complexity?

Splitting the corporate universe between large corporate and SME can add some risk sensitiveness via correct segmentation with a reasonably subdued cost.

Using external ratings where available, for banks that do not have internal ratings, is an invaluable source of risk sensitiveness if accompanied by a due self-assessment of the risk department of the institution.

Beyond that point, our impression is that further risk sensitiveness could only be achieved by increasing significantly in terms of cost and complexity.

Q8. Do respondents agree that introducing the specialised lending category enhances the risk sensitivity of the standardised approach and its alignment with IRB?

Specialised lending is a central source of financing to the economy through its financing of strategic sectors for economic growth: projects, objects, real estate and commodities. In Europe specialised lending represents around 10% of total corporate exposures and represents an invaluable source of finance.

We agree that specialised lending has a different risk profile but we cannot agree with the statement in the consultative document that *specialised lending generally exhibits higher risk and losses than other types of corporate lending*. We think such supposition does not hold true at least for relevant parts of the specialised lending asset class like Project finance, Object finance, Income Producing Real Estate (IPRE) and Commodities finance. We propose that the final risk weight is calibrated against factual experience and records on these activities. For that purpose, we would like to remind of the fact that typical corporate lending

is unsecured whereas specialised lending is secured by valuable assets and cash flows. Available studies⁵ illustrate the higher recovery rates registered on specialised lending.

In particular, certain elements of the proposal should be reviewed:

- The threshold of 120 % or in some cases and 300 % for special purpose vehicles without financial accounts would be excessive if they ignore the strong inherent mitigation provided by the specialised lending structure: ring-fenced structure, securities on valuable asset and in some cases on tangible cash flows.
- In Object Finance, typically Aviation and Shipping finance, borrowers are mostly ring-fenced and the asset class is bankruptcy-remote.
- It is common practice for owners and lessors to incorporate special purpose companies in countries where there is no legal obligation for them to issue accounts.
- We would argue that the lack of audited financial accounts for most Specialised Lending Object Finance does not generate additional risk. However, under proposed new guidelines, this prevailing market practice would automatically trigger a 300 % threshold, which is in our view disproportionate considering the actual risk related to closely monitored first priority secured loans.
- The definition of a minimum risk weight floor for specialised lending does not seem to fulfil the enhancement of the risk sensitivity of the standardised approach for this type of exposures. For example, a specialised firm with a revenue greater than 1 €billion and a leverage ratio of 100% would have a risk weight of 120% or 150%, whereas a similar firm with the same revenue and leverage ratio but non-specialised, would be assigned a risk weight of 60%.
- If the final risk weight is not calibrated against factual experience and records on these activities as proposed above, we reinforce that the suggested floors (120% and 150%) seem excessively high, namely in situations as the example presented before.

REMARKS ON INTERNATIONAL TRADE

International trade is a business which overall capital requirement is determined by the combination of various asset classes. For this reason, we think it important to make some remarks related to the treatment of international trade under the new standardised approach before entering into the discussion of specific asset classes following the order of the BCBS consultative paper.

Export Credit Agencies (ECA) play a crucial role in international trade. ECAs participating in the Arrangement on Officially Supported Export Credits⁶ supported by the OECD are safeguarding jobs in export oriented corporates, including SMEs. ECAs are offering unfunded credit protection of 95% to 100 % for loans to banks, corporates and sovereigns, which are often unrated, especially when they are established in low income countries. Due to their countercyclical nature ECA credit insurance and guarantees may help to overcome market disruption and maintain trade and exports also during crisis scenarios. We suggest to use external ratings for the portion of the loans covered by ECAs. The risk weighting of ECA credit

⁵ Standard and Poor's and Moody's studies on Default and Recovery Rates in Project Finance have provided evidence that recoveries are higher in this industry than in the corporate unsecured lending activity.

⁶ [Arrangement on Officially Supported Export Credits \(OECD, January 2014\)](#).

insurance and guarantees should be categorised according to the sovereign rating of the respective country supervising the ECA. If the loan is denominated in the currency of the supervising ECA the risk weight should be zero, for any other currency the following table should apply:

Credit assessment	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk weight	0%	20%	50%	100%	150%	100%

For the portion of the loans which are not covered by an ECA, if any, in the absence of external rating, banks may choose to use the risk scores published by individual ECAs that are recognised by their supervisors, or the consensus risk scores of ECAs participating in the OECD's Arrangement on Officially Supported Export Credits. This approach should be applicable to exposure to banks, corporates, SME, sovereign and specialised lending.

SUBORDINATED DEBT, EQUITY AND OTHER CAPITAL INSTRUMENTS

We support to differentiate between risk weights for equity and subordinated debt, including other capital instruments. The ranking in the creditor hierarchy should directly be reflected in risk weights as different LGD is reasonable to assume. As a consequence, we think that for subordinated debt applying an add-on on the risk weight of unsecured exposures will be a better option rather than a flat risk weight.

However, it seems that the introduction of a 300% or 400% risk weight for publicly traded equity and other equity issued by banks is inconsistent with the 250% risk weight such investment would have if it was a significant investment, that is exempted from CET1 deduction due to the 10% threshold exemption under Basel III. Thus for interbank exposures in equities and other Basel III compliant capital instruments the 250% risk weight should be applied.

Furthermore, we suggest that the Committee considers to let supervisors allow exempting the suggested 250% risk weight treatment for intra-group exposures towards such instruments and instead continue to treat Basel III compliant equities and other capital instruments with a preferential 100% risk weight. This would maintain the flexibility for banks and resolution authorities to apply a top-down approach for resolution planning and MREL/TLAC funding, as down streaming of capital to subsidiaries otherwise will be much more expensive.

There is currently no difference in the risk weights between subordinated loan capital and Additional Tier 1 (AT1) hybrid instruments (e.g. perpetual subordinated loan capital securities) in the proposal. Hybrid instruments are however riskier than subordinated loan capital as these have junior priority compared to the latter. This should be reflected in the risk weights.

In the proposal individual shares are given the same risk weights as equity funds. Equity funds are however considered less risky because of the diversification effect.

RETAIL PORTFOLIO



Q9. Can respondents suggest, and provide evidence on, how to increase the risk sensitivity of the regulatory retail exposures treatment, either by differentiating certain product subcategories for which a specific risk weight may be appropriate; or by suggesting simple risk drivers that could be used to assess the risk of all retail exposures?

The EBF considers that retaining the 75% risk weight approach to retail exposures is reasonable.

We would like to recommend extending the scope of application of the orientation criterion⁷ to cover medium-sized businesses as well. This is common practice in Europe, where an SME is deemed to be a business with up to 250 employees and a maximum turnover of euro 50 million.

We are opposed to any mandatory application of the granularity criterion. Lending precisely to SME's would be hit by such a rule. As a result, lending to SME's would be made much more expensive or reduced significantly. We are therefore against stipulating that retail portfolio diversification should be demonstrated through mandatory compliance with the granularity criterion and in favour of allowing other methods as well. At the same time, the limit for an aggregate exposure to any single counterparty should be raised to at least 0.5%.

As far as the criterion for the value of individual exposures is concerned, the absolute threshold of EUR 1 million causes many operational problems. If it is exceeded, there is need to gather a different set of data however the borrower keeps on being the same retail borrower. We would encourage the BCBS to recognise that a retail customer is a retail customer no matter the height of the exposure. If this is not considered, the current threshold should be raised in at least 50% to make allowance for inflation in the long period from the publication of the Basel II standard.

There are specific products with particular risk characteristics that could deserve a differentiated treatment. For instance, consumer credit loans supported by additional guarantees like the assignment of a part of the salary to cover the payment of the loan⁸ or mandatory insurance policies present a reduced risk profile *vis-à-vis* ordinary consumer loans. The EBF encourages the BCBS to maintain the right incentives that those guarantees offer by recognising the lesser risk involved.

In our view, the CRSA should remain simple for retail exposures. If, however, risk sensitivity should be enhanced, additional drivers could be taken into account. For instance:

- Variables associated with the history or stable relationship of the customer and transaction with the institution. In order to harmonise the definition of this relationship, the definition established in the European Commission delegated act with regard to liquidity coverage requirements for credit institutions could be explored. In this respect, a retail deposit shall be considered to be part of an established relationship where the depositor meets at least one of the following criteria:

⁷ Paragraph 34 of the consultative document.

⁸ Salary secured loans are commonplace in Italy (*Cessione del Quinto*), for example. Full details can be found in the response of the Italian Banking Association.

- It has an active contractual relationship with the credit institution of at least 12 months duration;
 - It has a borrowing relationship with the credit institution for residential loans or other long term loans;
 - It has at least one other active product, other than a loan, with the credit institution.
- The maturity of the loan.

The BCBS could also consider the risk mitigating arrangements included in certain retail transactions like loans paid by receivables (e.g. commercial, service and credit card receivables, payroll payments, rents, long-term public concessions), or collateralised by durable goods (e.g. vehicles) that meet specific requirements.

CLAIMS SECURED BY REAL ESTATE

We believe that it is neither possible nor appropriate to globally harmonize a detailed system for risk weights for residential real estate. A variety of factors influence the risk incurred by residential lending, for example the way the housing market operates, the systems of property valuation, registration and pledge of housing and design of legal and the welfare systems. To the extent that risk weights are to be differentiated under the standardized approach the calibration should therefore be decided on national level.

It is quite obvious that national circumstances are very important both for the choice of valid risk drivers and for the calibration of appropriate levels for risk buckets. The probability of losses for households are obviously very different if the bankruptcy law allows people to walk away from debt without severe repercussions compared to if there are no personal bankruptcy where debt is written off, meaning that the debt remains with a defaulting borrower for the rest of the borrower's life.

However, from a practical point of view, we think that the LTV, with some considerations and complements, could meet to a large extent the objectives pursued by the Committee. However we foresee too many problems which are difficult to get around in the case of the DSCR. Our arguments are explained in the responses to the next questions.

In the case of the DSCR, the range of practical complications makes it unmanageable and we would suggest testing other alternatives.

Specialised mortgage lenders could be particularly affected by the risk weight framework proposed mainly in economies with long tradition for this type of mortgage financing. The risk weight calibration will in particular impact these countries as mortgage loans typically ranges with LTVs of between 60% and 80%. In the current standard approach these receives a 35% risk weight whereas it is 40% or 50% in the proposal. Local calibration of the global standard will help to capture these relevant specificities.

Q10. Do respondents agree that LTV and/or DSC ratios (as defined in Annex 1 paragraphs 40 and 41) have sufficient predictive power of loan default and/or loss incurred for exposures secured on residential real estate?

The LTV is one of the simplest proxies of risk that is widely available, but not the only one. In terms of risk discrimination, we recommend the BCBS to test the discriminatory power of the number of days in arrears. According to the EBF study on IRB models for residential mortgage loans⁹, the LTV is the second most widespread form of segmentation only after the regional dimension. This offers two benefits to the use of LTV:

1. Firstly, there is much information available;
2. Comparisons between the IRB results and the output of the new standardised approach will be straight if a bit of coordination is put in the definition of LTV bands.

Nevertheless the LTV presents certain shortcomings and problems that need to be sorted out, namely:

- There should be more granularity in the lowest risk LTV bands. Once the data is collected, this can be done at no extra cost and it will definitely increase risk sensitivity and enrich comparability across methods and banks.
- Regarding the option of dividing the capital requirements in tranches, we understand the problems noted in the consultative paper¹⁰ but we would also like to point out that the only alternative seems to be the use of the full exposure and it could bring about other sort of problems which effects are undesirable. For instance, there would be cliff effects. This would tend to group loans around borderline LTV values. A plausible solution is to update the LTV.
- The legal framework plays an important role in the performance of the mortgage guarantee for risk mitigation purposes. A variety of factors influence the risk incurred by residential lending, for example the way the housing market operates, the systems of property valuation, registration and pledge of housing and design of the legal and the welfare systems. To the extent that risk weights are to be differentiated under the standardised approach the calibration should therefore be run at local level.

The DSCR would be a sound indicator if could be easily updated as it portrays the borrower's capacity to repay the debt at all times. But it poses various problems in terms of measurement and comparability:

- There is no common definition of DSCR and formulating one that works seamlessly across countries seems really unimaginable.
- There could be an issue of legal right to reassess the affordability of borrowers on an ongoing basis.
- The DSCR is typically used in the credit application approval process of banks as an indication of the borrower's capacity to pay. But risk management practices do not lead to conclude that riskiness is a linear function of DSCR. It is used just as a backstop: If evidence indicates that the borrower can hardly afford the payment of instalments with the declared income then the bank should not grant the loan.
- The valuation of DSCR at origination does not reflect the risk of the exposure in the long term.

⁹ <http://www.zyyme.com/zh5/83493#p=0>

¹⁰ Footnote 22 of the BCBS consultative paper.

Q11. Do respondents have views about the measurement of the LTV and DSC ratios? (In particular, as regards keeping the value of the property constant as measured at origination in the calculation of the LTV ratio; and not updating the DSC ratio over time.)

The LTV should be updated on the side of the numerator by taking the outstanding amount of the loan at each point in time. It is easy because it is data readily available in IT systems. It is fair because the risk profile of the mortgage loan changes so long as the remaining debt decreases. Regarding the denominator, an increased or decreased market value of the dwelling should reflect the risk weight for the exposure, otherwise LTV as a risk driver will provide less and less relevant information about the risk of loan losses as time elapses after the loan origination. The problem is that mandatory property revaluations can be expensive and complex. For this reason, it should be allowed to banks, though not mandatorily, to calculate LTV based on the current market value.

In practice the inputs from origination in debt service coverage are normally static. Regularly updating the DSCR in particular would be difficult to achieve both in terms of time involved and willingness of borrowers. Therefore, updating the DSCR should also be allowed but not mandatory.

For Buy-To-Let lending, we recognise that income from property is not used as debt service coverage. However we feel there should be some recognition of such income.

Q12. Do respondents have views on whether the use of a fixed threshold for the DSC ratio is an appropriate way for differentiating risks and ensuring comparability across jurisdictions? If not, what reasonably simple alternatives or modifications would respondents propose while maintaining consistent outcomes?

The problems associated with the use of DSCR as a risk factor come from the uneven and varied realities of the economies, market characteristics and local laws that ultimately affect the appropriateness of DSCR levels as risk indicator.

The DSCR is according to the proposal based on the borrower's net income. This presents several problems:

- The net income after taxes and social benefits can be difficult to control for the lender.
- It is not as straightly comparable as it might seem due to differences in health care and welfare systems designs including fiscal and privately funded systems.
- Tax systems will have very different for implications for the DSCR. In some countries, a lot of costs for households, like education and health care, are paid over the tax bill while for other countries the same costs are funded with the household net income. These differences mean that a DSC after tax will mean something very different in a country where tax levels are high compared to a country where most living costs are paid privately and taxes are kept low.

The real-world complications of DSCR cannot be overcome by adjusting the thresholds without giving rise to bigger difficulties. Only a national method for measuring the economic

strength of the household could make the results meaningful and comparable at national level.

Q13. *Do respondents propose any alternative/additional risk drivers for the Committee's consideration in order to improve the risk sensitivity in this approach without unduly increasing complexity?*

We would like to propose the BCBS to investigate and possibly include the following complementary factors alongside the LTV:

1. An additional factor may be the ratio of the outstanding amount over the original principal amount of the mortgage loan. Clients who have repaid a large amount of the original loan may have a strong incentive to pay the remainder.
2. Owner-occupied properties have a risk profile unlike other types of mortgage loans like buy-to-let, for example. Owner occupation would be a binary segmentation variable that could offer a lot of discriminatory power at an insignificant cost because it is easy to obtain and to store, stable and easily verifiable by auditors and supervisors.
3. The liability of the borrower beyond the pledged value of the property is another factor that explain the risk profile of the mortgage loan market in many countries. We understand how difficult it is to quantify its effect in a simple model but if calibration is run at national level, the liability of the borrower will be somehow included in such local calibration.
4. The age of the loan has proved to be a reliable risk factor in the many asset quality reviews conducted after the crisis. Mortgage loans older than 7 years showed a slump in credit losses even in markets harshly hit by a sharp decline in housing prices.
5. Additional guarantees do change substantially the risk profile of mortgage loans and should be considered without adding too much complication. For instance:
 - a. Parent guarantees are commonplace and could enhance the value of the guarantee.
 - b. There exist unemployment insurance policies.
 - c. Private insurance schemes like the *Crédit Logement* in France.
 - d. Public guarantees like the *Nationale Hypotheek Garantie* in the Netherlands.

Q14. *Which of the two options above is viewed as the most suitable for determining the risk-weight treatment for exposures secured on commercial real estate?*

The evaluation of both options is only possible if further clarifications are provided regarding the national discretion for a preferential 50% RW under option A. The criteria underlying such discretion may influence significantly the RWA figures, if less restrictive, as it differs

substantially from the possible risk weight values defined in option B (table on page 38 – risk weights of 75%, 100% and 120% according to different LTV intervals).

The treatment of Commercial Real Estate (CRE) as unsecured, as proposed in option A, does not seem to reflect the effective risk of these exposures, departing from an opposite view, which has been present in all European risk assessment exercises in recent years, that considers CRE as secured exposures. We think that some reduction compared to unsecured exposures risk weights should be granted to recognize the value of collateral. Furthermore, an LTV approach, as proposed in option B, seems to ensure a greater alignment with IRB treatment because it departs from the customer nature perspective (as defended in option A) and approximates to a collateralization level perspective.

Q15. What other options might prudently increase the risk sensitivity of the commercial real estate treatment without unduly increasing complexity?

As mentioned in the answer to question 11 for Residential Real Estate, the LTV should not be computed with the collateral value at origination date for the loan lifetime, but with the most recent appraisal available.

RISK WEIGHT ADD-ON FOR EXPOSURES WITH CURRENCY MISMATCH

Q16. Do respondents agree that a risk weight add-on should be applied to only retail exposures and exposures secured by residential real estate? What are other options for addressing this risk in a simple manner?

No comment.

OFF-BALANCE SHEET EXPOSURES

The introduction of a 10% floor on low risk off balance items would have an effect on credit lines to financial counterparties. This will impact especially institutions in small currency areas which often have a limited number of money market counterparties. Furthermore, this will make it more expensive to make market-making since it potentially impacts the trading lines.

The 10% CCF is all the more unjustified in the corporate segment owing to the fact that counterparties are closely and continually monitored, therefore an immediate reduction of the credit line can also be enforced. For this reason we think it appropriate to keep the 0% risk weight, or a preferential risk weight of 2%, in the corporate segment for commitments that are unconditionally cancellable at any time without prior notice.

In order to enhance risk sensitivity and strengthen the link between the standardised approach and the IRB approach, we propose to include the following ratios as additional drivers to determine the CCFs:

- The credit revolving utilisation ratio which represents the credit balances relative to the credit limits on the revolving should be calculated not only at aggregate level but also at individual level, as long as the credit card is still valid.
- The commitment maturity which is an important driver that is considered in the current standardised approach and in the IRB approach.

Q17. Do respondents consider the categories for which a CCF is applied under the standardised approach to be adequately defined?

Overall, the CCF's appear too high to us. That goes particularly for commitments to corporates that a bank may unconditionally cancel at any time without prior notice, as these are monitored closely and there are no conflicting consumer protection rules. But the 75% CCF for commitments that are not unconditionally cancellable at any time without prior notice is likewise too high in our view.

We also wish to point out that raising the CCF's has a direct impact on the size of the leverage ratio, so that this overlapping effect should be taken into account.

For commitments, except unconditionally cancellable, a CCF is set at 75% instead of 20% or 50%. This will have a significant impact on the exposure amount (EAD) included in the RWA calculation as well as in the leverage ratio calculation and large exposure regime in certain jurisdictions.

Q18. Do respondents agree that instruments allocated to each of the CCF categories share a similar probability of being drawn and that the probabilities implied by the CCFs are accurate? Please provide empirical support for your response.

Introducing CCF on commitments which are unconditionally cancellable could have unintended consequences in terms of liquidity in the wholesale markets.

With reference to consumer protection rules, we can understand the 10% CCF for retail commitments that are unconditionally cancellable at any time without prior notice. There are no consumer protection rules to this effect in the corporate segment, however. Corporates are, as a rule, monitored closely, so that an immediate reduction of the credit line can also be enforced. We therefore continue to regard a 0% risk weight in the corporate segment for commitments that are unconditionally cancellable at any time without prior notice as appropriate.

It is unclear why the proposed 75% is deemed more appropriate than the existing 50% and 20% CCF values which distinguish between commitments less than and greater than one year in duration, particularly as maturity is explicitly recognised under the IRB Foundation Approach. Doing away with the maturity distinction eliminates risk sensitivity and penalises off-balance sheet exposures, in particular documentary letters of credit, acceptances and

guarantees, which are typically short-tenor in nature, and are core to the overall capacity of the banking industry to finance international commerce.

PAST-DUE LOANS

Q19. What are respondents' views on the alternative treatments currently envisaged for past-due loans?

The upcoming changes to accounting standards (IFRS 9) will result in a comprehensive framework for the expected loss of past-due assets. Given these developments, the unexpected loss should not rise unduly and could remain equal to the treatment of the corresponding performing (non-past-due) asset.

Provisions should be considered when determining the risk weights.

EXPOSURES TO MULTILATERAL DEVELOPMENT BANKS

Q20. Do respondents agree with the proposed treatment for MDBs?

We propose that further clarification should be provided regarding the following points:

- The criteria to assess a MDB as a “Qualifying MDB” and to maintain the treatment according to the external credit rating (points (iii) to (v) on page 30) seems subjective and difficult to put in practice. We propose that a list of MDBs that comply with those requirements should be disclosed and mandatory to ensure harmonisation across EU jurisdictions.
- As proposed, qualifying MDB should be treated as bank exposures. However, with the proposed text, bank exposures will start being risk weighted according to CET1 and NPA values, different from the current approach that considers the ECAI grade of the bank. A clarification should be provided to define if qualifying MDB will be treated as banks, according to the current approach (rating grade) or according to the new approach (CET1 and NPA).

OTHER ASSETS

Q20. What exposures would be classified under “Other assets”? Is a 100% risk weight appropriate? (Please provide evidence where possible).

According to the proposed rules text, the standard risk weight for all other assets will be 100%. Whereas cash as eligible financial collateral is explicitly mentioned and receives a 0% haircut, cash in hand and equivalent cash items that do not serve as financial collateral are not addressed accordingly in the 'other asset' class. Therefore we strongly propose to include a risk weight of 0% for cash in hand and equivalent cash items. In addition, gold bullion held in own vaults or on an allocated basis to the extent backed by bullion liabilities can be treated as

cash and are therefore risk-weighted at 0%. In addition, cash items in the process of collection can be risk-weighted at 20%.

CREDIT RISK MITIGATION FRAMEWORK

We are opposed to any general ban on using internal estimates and models. Instead, banks which already have approved methods in place to mitigate credit risk should also be allowed to use these for CRSA purposes, as they are much more risk-sensitive than, for example, supervisory haircuts.

Q22. What are respondents' views on the above alternative ways to define eligible financial collateral?

Banks would experience a serious increase in capital from this proposal. We think it is unwarranted. At present under IRB, banks can benefit from CRM for physical collateral. We do not think it appropriate to compare risk on unsecured debt as opposed to the low risk from a well-secured, saleable physical asset.

Collateral in the form of UCITS and mutual funds is widely used by customers, who appreciate the quality, the stability and the liquidity of these well-regulated investment vehicles. The current prudential framework, as well as the one under consultation, recognises shares of UCITS and mutual funds as financial collateral. For the purpose of the look-through approach, such collateral is considered eligible if the shares have a daily public price quote and if the UCITS and mutual funds are restricted to solely invest in other assets eligible under the CRM framework¹¹.

We believe that the latter condition is too restrictive because it constitutes a binary approach, where UCITS and mutual funds holding a limited percentage of non-eligible assets have no value for CRM. This treatment excludes from the CRM eligibility a broad range of UCITS and mutual funds, thus reducing the borrowing capacity of customers and the lending capacity of banks. In order to introduce a more risk-sensitive framework, we recommend that banks be allowed to apply a partial look-through on the eligible assets held by the UCITS and mutual fund. As a safeguard to the recognition of this partial look-through, we also suggest to limit the percentage of non-eligible assets held by the UCITS to a maximum of 50% of the total portfolio.

Q23. What are respondents' views on the recalibrated supervisory haircuts shown in Table 4? What are respondents' views on how to eliminate references to ratings from the supervisory haircuts table? What could be the implications of eliminating references to external ratings?

In practical terms, eliminating the ratings from the CRM haircuts allocation process force to abandon a simple and automatic process of obtaining information via Bloomberg to, somehow, collect and maintain information of issuers of securities received as collateral

¹¹ Paragraphs 92 and 104 of the consultative document.

completely identical to information that will be necessary, according to the proposals in this consultation, to determine the risk weight of the remaining counterparts.

Q24. *What are respondents' views on the proposed corporate guarantor eligibility criteria?*

No comment.

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