



Basel Task Force - FELABAN

Comments to the document "Revisions to the Standardized Approach for Credit Risk - Second consultative document"

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1. Introduction

On December 10, 2015, the Basel Committee on Banking Supervision (BCBS) of the Bank for International Settlements (BIS) located in Basel, Switzerland, published the working document *"Revisions to the Standardized Approach for credit risk: Second consultative document,"*¹ with the goal of continuing strengthening the regulation, supervision and good practices of the banking sector globally and strengthening its financial stability.

In summary, regarding the first consultative document published in 2014, this new document reintroduces the use of credit ratings issued by credit rating agencies to determine exposure to banks and companies. This in order to meet the goal set forth in the first document, of *"balancing simplicity and risk sensitivity and promoting comparability by reducing the variability of risk weighted assets across banks and jurisdictions, as well as guaranteeing that the Standard Method constitutes an alternative and valid complement to the Internal Ratings-based Approach (IRB)."* In addition to the above, and complying with the goal of reducing dependency on external ratings to measure counterparty exposure, the Committee proposes alternatives for cases where external ratings are not available or when these may not be used for regulatory purposes.

On the other hand, the consultative document includes adjustments in the Standard Method (SA) in order to increase comparability among jurisdictions, without reducing its sensitivity to risk. Thus this approach seeks to become a valid and supplementary alternative to the Internal Ratings-based Approach (IRB). Since this is a minimum universal standard, however, it shall always be difficult to consider the particularities of each jurisdiction under a single approach.

¹ Available in English and Spanish on the website <https://www.bis.org/bcbs/publ/d350.htm>

Finally, regarding other categories and exposures, following the evidence produced by the first Quantitative Impact Study (QIS) of 2015, as well as the comments document prepared by FELABAN on the first consultative document, the Committee made adjustments to exposure to companies via specialized financing, retail portfolio, real estate, off-balance sheet positions and exposure to currency mismatch, among others, which generated a wide variety of opinions in the Latin American banking sector. We greatly appreciate the fact that the Committee considered our comments, especially by incorporating external ratings, Project Finance operational stages and counterparty risk weight for high LTV ratios for Real Estate exposures, and by eliminating the DSC criteria and the punitive 300% RW for Corporates without available data.

Although FELABAN values the dedication and work of the Committee that led to the second consultative document, the Latin American banking sector believes this document can be enriched through further review and feedback regarding certain specific aspects of its contents. The main goal is to help mitigate potential medium and long term imbalances or undesired consequences as a result of its implementation in Latin America.

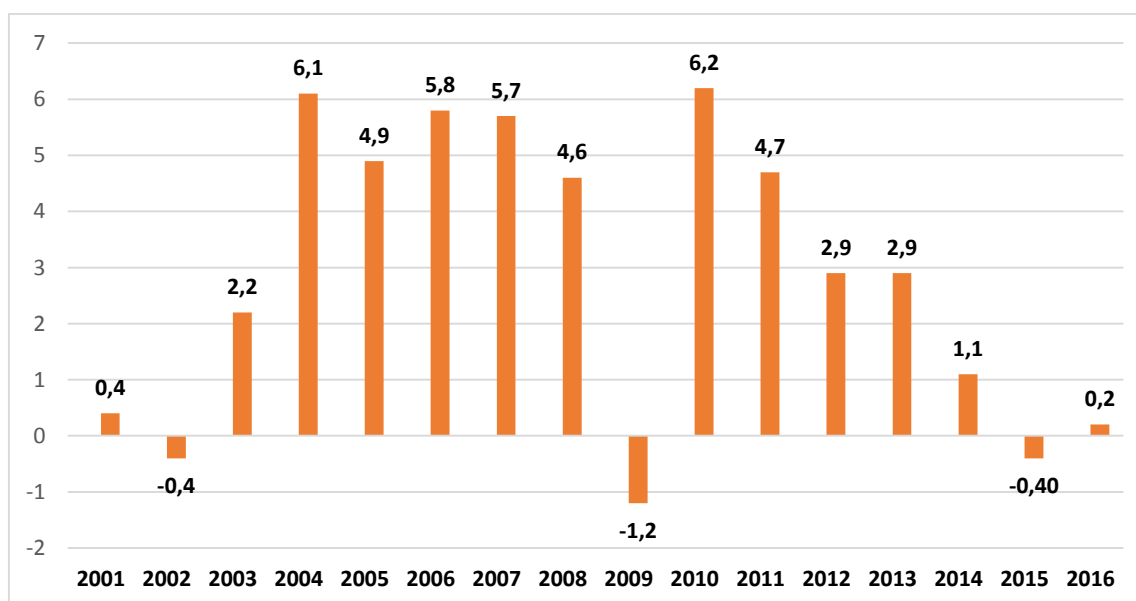
FELABAN will continue to make both general and specific contributions on behalf of Latin American banks. Just as it did in 2015, in this document FELABAN provides an analysis that enriches technical and academic discussions in order to strengthen its banking sector, so that the financial risks it faces may become increasingly more identifiable, predictable and manageable.

2. General context for Latin American banks

During 2015 the Latin American economy entered into a recessive period. The International Monetary Fund and the Economic Commission for Latin America and the Caribbean (ECLAC) ratified the fact that during 2015 and 2016 the region as a whole was set to experience negative or close to zero economic growth. Furthermore, the slowdown in China, interest rates hikes in the United States and the financial and exchange volatility that this has caused globally, added to the sharp drop in the price of basic commodities, have led to growing current account deficits in most of Latin American nations. Fiscal revenues have fallen and the exposure of companies with foreign currency loans has increased. This being the state of affairs, economic activities have lost steam and this has manifested in two key variables: household consumption and private macroeconomic investment.

Graph 1

Real GDP Growth in Latin America



Source: Economic Commission for Latin America, December 17, 2015. The data for 2015 and 2016 are based on estimates.

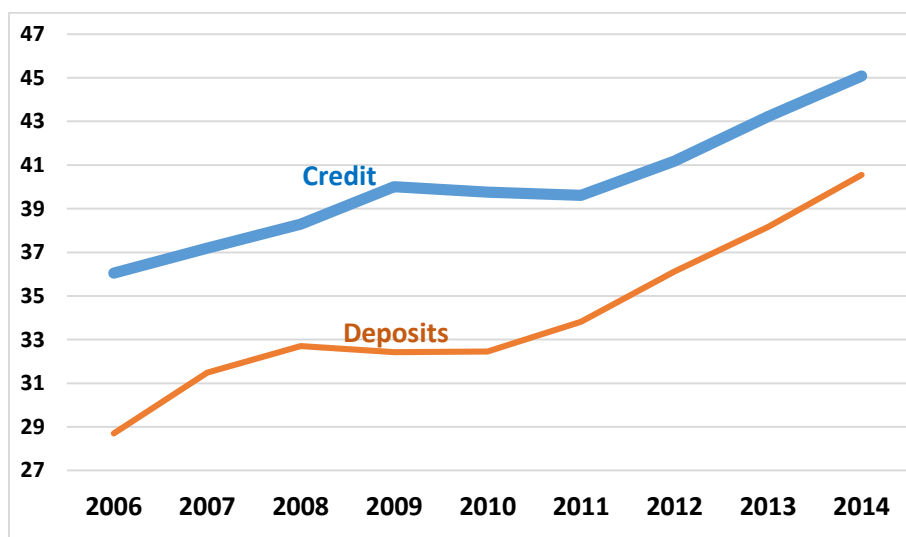
The effects produced by the drop in the price of basic commodities have attracted less foreign direct investment. One of the short term indicators of this new macroeconomic situation has been the marked devaluation observed in foreign exchange rates.

While the regional central banks are largely independent and have “munition” available to address this situation, reflected in terms of international reserves, the devaluation seems to have materialized in the real economy with an increased *pass-through* effect that exerts pressure on inflationary trends in the region.

In this context some countries have increased their exposure to the effects of exchange rate volatility. Some financial sectors are facing the consequences of having their financial services indexed to the US dollar, with undesirable results for debt holders, who have seen their debts rise and who will now require more domestic currency to service their debts.

Graph 2

Credit and Deposits as a % of GDP from 2006 to 2014 in Latin America



Source: FELABAN 2015 Survey, which included 18 countries in the region.

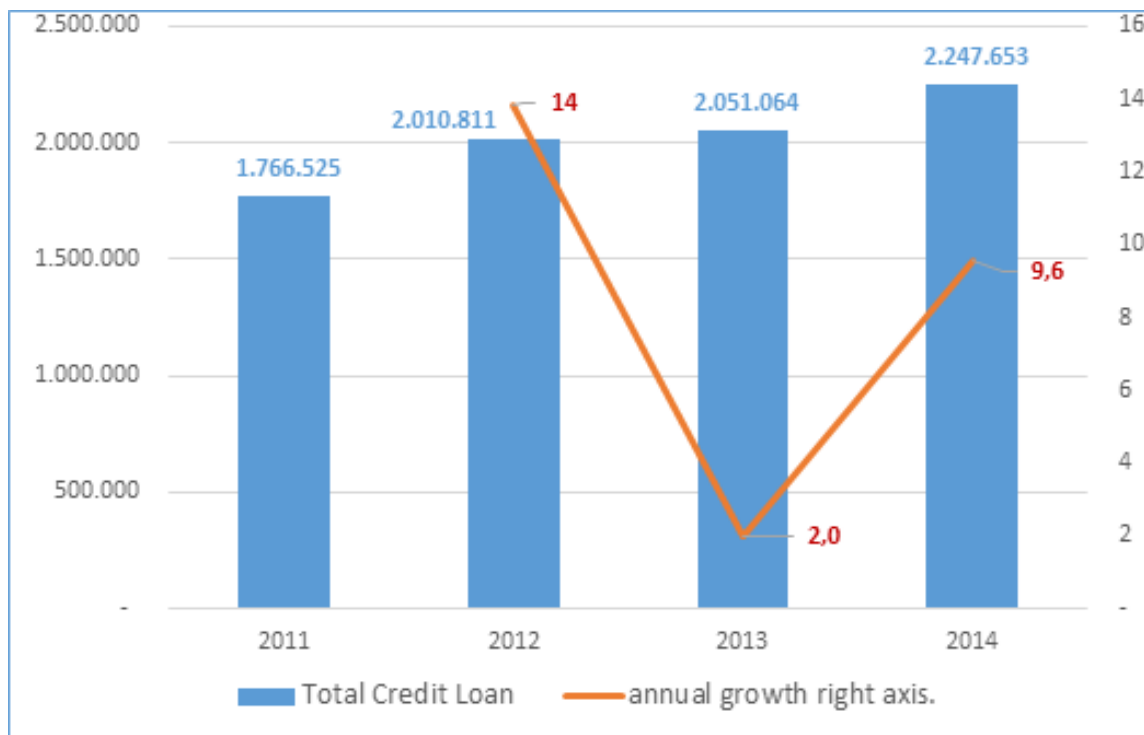
In other cases, both banks and the financial sector in general would have to face the rising costs of their obligations in currencies such as the US dollar and the Euro. Private external debt has grown, and as a result banks have less room to maneuver in international financial markets.

Given the growing inflation, regional central banks face the dilemma of raising their domestic interest rates in order to reduce aggregate demand, and thus vent inflationary pressures. The cost of this policy is a deterioration in the level of economic activity, with the economy already in the trough of the cycle. Currently a prolonged rise in inflation rates would imply loss of credibility regarding the annual price goals set by monetary authorities. In this scenario, countries facing rising domestic prices are expected to harden the terms of their monetary policies. This, of course, means less liquidity for the financial system in general.

We should state that Latin American banks are in good financial health. In recent years credit supply has been significant, financial depth has increased, larger sectors of the population now have access to formal financial services, and its solvency has remained stable. Sectors such as consumer loans have noticeably improved their coverage and service in recent years.

The region undoubtedly needs to grow. To this end it is important that the equation be properly managed, conjugating the variables of security, regulation and supervision with the highest standards, and a business environment that allows for improved sector competitiveness.

Graph 3: Evolution of the Latin American Banking Portfolio 2011-2014 (in billions of USD)



Source: FELABAN 2015 Survey of 18 countries in the region

3. General Comments

The Latin American banking sector celebrates the recognition of the limitations to the approach of the two risk factors, and instead, the reintroduction of external credit ratings. Although the Committee's intention of reducing dependency on ratings is understandable, we also believe that external credit ratings help promote the goal of balancing risk simplicity and risk sensitivity.

In general terms we have to say that, to date, we are unaware of the way the indexes, coefficients and risk weight factors included in the second consultative document published by the BCBS were created, and what methods were used to that effect. Getting to know this construction would be extremely useful for all members of the banking sector (and not just for the Latin American one). Furthermore, we believe that the indexes have been created for developed nations, and that many of them are not applicable in a context of emerging nations such as the Latin American ones.

It should also be said that the spirit of the proposal of the Basel Committee on Banking Supervision implies greater capital requirements. In the opinion of FELABAN, this needs to be very well justified by supervisors. We believe that to the degree that better techniques are proposed to improve sensitivity to risk, the process of mitigating and managing risk can contribute to the financial stability required by the industry, supervisors and society in general.

4. Exposures to banks

The External Credit Risk Assessment Approach (ECRA): The Latin American banking sector disagrees with the results of the due diligence requirement regarding the exposure of banks with available external ratings.

FELABAN specifically disagrees with the BCBS proposal that the due diligence process can never produce a risk weight assessment below the one determined by the external rating. We believe this condition violates the nature of the due diligence process and the added value created by the analysis of a bank vis-à-vis its banking counterparty. We also believe that, with appropriate results, an adequate due diligence process can produce a lower risk weight. Otherwise this becomes a requirement that adds no value to the risk management process.

Revisions to the Standardized Approach for credit risk (SCRA):

Paragraph 30 sets forth that securities companies and other financial institutions not subject to the capital and liquidity requirements that banks are subject to, shall be treated as companies (that is, RW of 100% if no external rating is available). Particularly noteworthy is the fact that liquidity requirements are mentioned (in addition to capital requirements), since this may affect organizations in jurisdictions that have not yet transposed Basel III into domestic regulations.

Moreover, small, regional or niche banks, specialized in serving a specific sectors of the population or specific financial solutions, would be more severely penalized, with the consequent impact on credit supply to underserved sectors. This would become a disincentive to the goal of generating greater financial inclusion. It must be stated that the greater simplification and comparability sought by the BCBS with these models has an underlying cost, which is the non-inclusion of the particularities of smaller organizations that are serving specific markets. It is highly likely that these models fail to consider specific factors that contribute to appropriate risk management process.

Country risk weight floor: Regarding the proposal of a minimum risk weight for exposures to banks, we believe country risk should not be taken into account if the exposure is financed in local currency, since this type of

transaction implies no exchange, convertibility and/or transference risks. However, understanding the concerns of the BCBS, we wish to propose the introduction of the “AA” rating category for banking counterparties exceeding the minimum requirements and regulatory buffers of each jurisdiction by 120%, without the need for such exposure to be subject to a minimum risk weight.

In addition, the external ratings of banks that should be considered are those based on national rating scales, if available, for exposures financed in local currency in each jurisdiction. This would increase alignment with the liquidity framework, which permits the use of local rating scales when both exposure and funding are denominated in local currency (according to footnote 21 of “Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools,” January, 2013).

Short term interbank exposures: When addressing short-term interbank exposures,, the proposal establishes a difference between exposures to periods greater and less than 3 months, with the proposed coefficients considerably being higher between risk weight to long term exposures –more than 3 months— and risk weight for short term exposures (20% vs. 50%, or 50% vs. 100%). Since we do not know how these numbers were calibrated, it is therefore difficult to produce a technical comment in this regard. However, given the relevance of this type of transaction set for more than three months, it would be good to assess its coefficient and/or to establish a greater risk factor graduation (that is, to avoid such discrete jumps between external ratings). Regarding this point we respectfully request clarification of the financial policy incentive or intent that lies behind this proposal, since the rest of the liquidity recommendations proposed by the Basel Committee on Banking Supervision (BCBS) precisely seek to extend funding terms, under conditions of less financial tension for financial organizations and markets in general. The above considering that in emerging nations the banking, financial and capital sectors have relatively less depth and smaller sizes compared with those of developed nations.

5. Exposures to companies

In Latin America, as well as in the majority of emerging markets, the universe of companies with credit ratings is very small. This implies that the Standard Method proposed by the BCBS is insensitive to risk in our region, and in general terms assumes strong penalization for risk exposure to companies in emerging economies. We believe this should be addressed in the new proposal, and to this effect we propose that, just as an alternative to the use of external credit ratings has been established for banks, an optional alternative treatment should be defined for companies that have no external credit rating available.

On the other hand, we suggest considering the possibility of applying a flat risk weight of 75% for exposure to companies that have no available credit rating, in jurisdictions where its use is permitted for regulatory purposes (in the document, the Committee proposes applying a weight of 75% to companies that fulfill the criterion of "investment grade" in jurisdictions that do not permit the use of external ratings for regulatory purposes). This, in order to replicate and align the treatment given to SMEs.

Furthermore, FELABAN would like to propose the possibility that regulators in each jurisdiction may autonomously define additional criteria to better adapt to the particularities of those whom they supervise, or define broader criteria, such as having audited financial statements. The above, for example, taking into account the fact that the proportion of companies listed in a stock exchange significantly differs between developed and emerging economies. This can be illustrated by World Bank figures to this effect.² The World Bank financial development indicators database shows that in Latin America approximately 863

² <http://datos.bancomundial.org/indicador/CM.MKT.LDOM.NO/countries?display=graph>

national companies are listed in local stock exchanges. This figure contrasts with the Eurozone, which has 5,413 companies listed in local stock exchanges. What is normal for the region is that companies capable of accessing capital markets are large companies that can either access stock exchanges, bond issuing or similar instruments. Inter-American Development Bank estimates indicate that large companies represent 0.4% of the regional economy on average. This constitutes sufficient evidence in terms of stating that only a small number of companies have access to credit ratings.

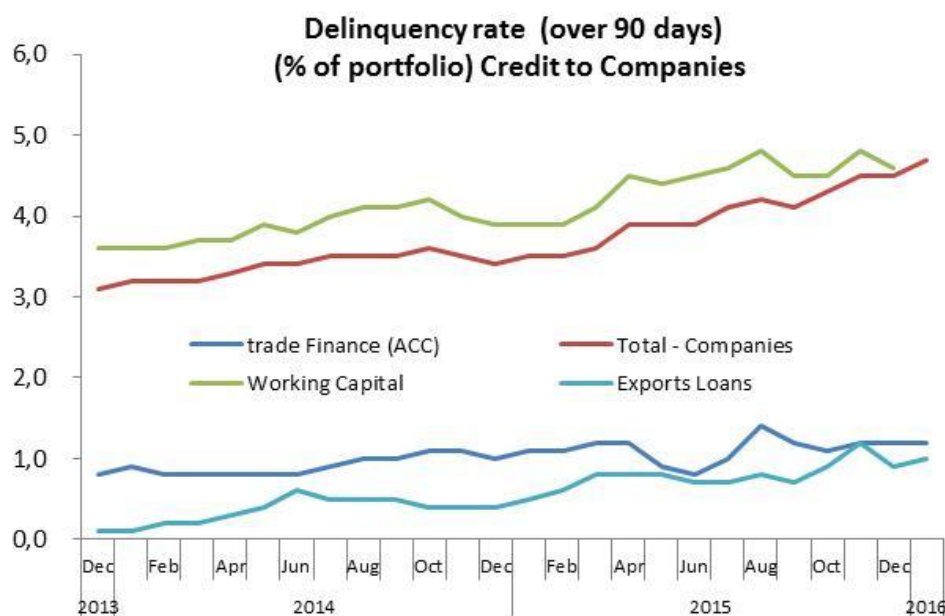
Percentage share of companies in each economy according to its size

	Micro	Small	Medium	Large
Argentina	81.6	16.1	1.9	0.4
Brasil	85.4	12.1	1.4	1.0
Chile	90.4	7.8	1.2	0.6
Colombia	93.2	5.5	1.0	0.3
Ecuador	95.4	3.8	0.6	0.2
México	95.5	3.6	0.8	0.2
Perú	98.1	1.5	0.3	0.1
Uruguay	83.8	13.4	3.1	0.6
Regional Average	90.4	8.0	1.3	0.4

Source: Inter-American Development Bank 2013

Finally, the 2015 ICC report on Trade and Export Finance uses a Basel-compliant measure of risk to demonstrate a relatively low default rate on short-term loans for Import/Export. While the default rate of 6.8 million contracts worldwide from 2008 to 2014 was 0.22%, the same obligors had a default rate of 0.72%. Also, the products are very liquid (Short-term Trade Finance) and losses in the case of a default are relatively low. This leads to a low overall Expected Loss.

Graph 4: Delinquency rate (>90 days) as a percentage of portfolio – Credit to companies



Source: Brazilian Central Bank

6. Exposures to companies through specialized financing

Specialized loans are a fundamental working tool for emerging economies. Specialized credits facilitate private investment in physical infrastructure projects that produce high impact in the economy given their dynamic effects on employment and intermediate consumption. The significance is greater considering that in many emerging markets the funding sources of the securities market are more limited and have less depth. In this sense specialized credits are tools that make it possible to structure long term project financing.

Estimates of the Andean Development Corporation (CAF) indicate that LatAm invests close to 1.5% of its GDP in infrastructure, and point to its need to invest 5% of its GDP just to overcome the lag in current variables. According to the

Economic Commission for Latin America and the Caribbean (ECLAC)³, if Latin America wants to reach Southeast Asian levels it will need to invest 8% of its GDP in infrastructure.

In this sense we would like to reiterate that imposing costs and difficulties on the financing of this segment of the portfolio produces adverse consequences for this type of investment projects.

Specialized loans are tools capable of financing physical infrastructure projects (ports, roadways, and airports), social capital (hospitals, schools, dams) and exploitation projects (mining, agriculture). Given their nature, default rates are low as they have underlying collateral, government guarantees and limited legal risks. In this sense, risk assessment based on a standard model may ignore the specific conditions that underlie each project and may end up underestimating the respective associated financial risk.

It is therefore necessary to acknowledge the value of guarantees, take into account the specificities of each project, count on granularity, and determine risks based on the work performed by experts in the specific related industry.

This type of instrument is vital for Latin America, given its infrastructure lag and the scant development of its capital markets. Without such an instrument, if the proposals of the Committee contained in this consultative document were to be adopted there is the risk of de-incentivizing the banking industry from

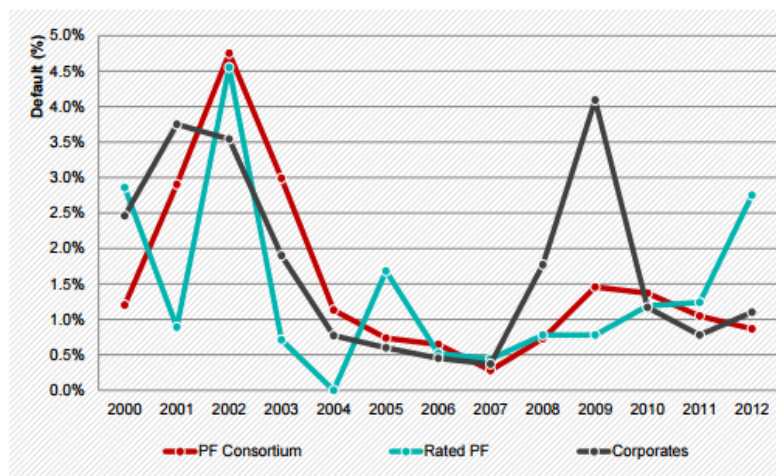
³ La brecha de infraestructura en América Latina y el Caribe [The infrastructure gap in Latin America and the Caribbean]. CEPAL, July, 2011.

accompanying these projects and giving room to such activities as *shadow banking*.

International studies based on specialized lending (Project Finance) loss rate over 2000-2012 show that the SA proposal seems overly conservative. The default rate and LGD of specialized lending indicated an RW below that of the proposal.

Graph 5: Default rate for selected specialized financing projects per sector

Standard and Poor's Rating Services has rated 514 project finance debt issues since 1991. The annual average default rate is 1.5%



Source: S&P, Global Project Finance Performance Update

7. Subordinated debt, equity and other capital instruments

The BCBS considers that a RW of 250% applies to share positions that are not deductible on account of risk. We believe this is too conservative, however, compared with other types of exposures (for example, 100% to 150% weights

when the exposure is in default, or even 150% for investments in subordinated debt).

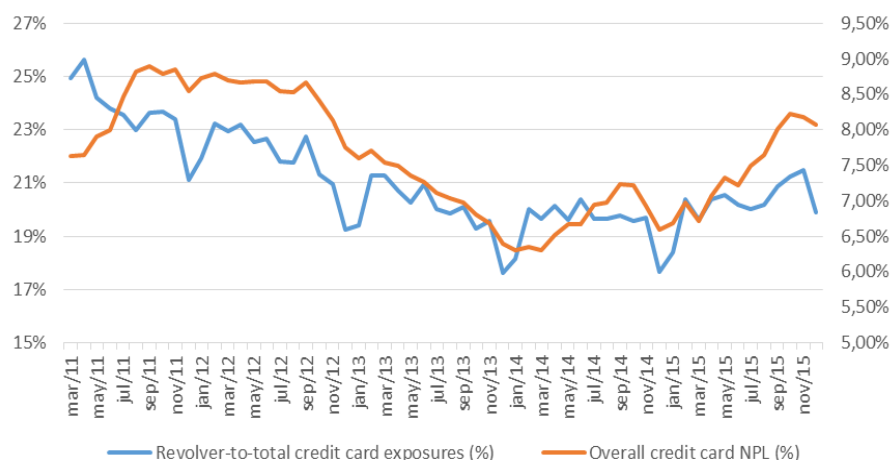
If a bank sells its share positions, an investment of insignificant amounts will tend to be more liquid and therefore subject to lower discount rates in capital markets. Therefore they could be subject to a constant risk weight of 150% (instead of 250%, which is the risk weight proposed for share investments that are not deducted).

8. Retail exposures

The proposed increase in CCFs for unconditionally cancelable (from 0% to 10-20%, restricted to retail) and other commitments with maturity (from 20-50% to 50-75%) disregards important risk drivers, which may promote unintended incentives to operate with high-risk customers. For instance, there is no risk weight differentiation for credit lines to clients that barely use their credit card and overdraft limits (low utilization-to-income rate), or use and pay their credit card lines as “transactors”, without interest charge (instead of “revolvers”).

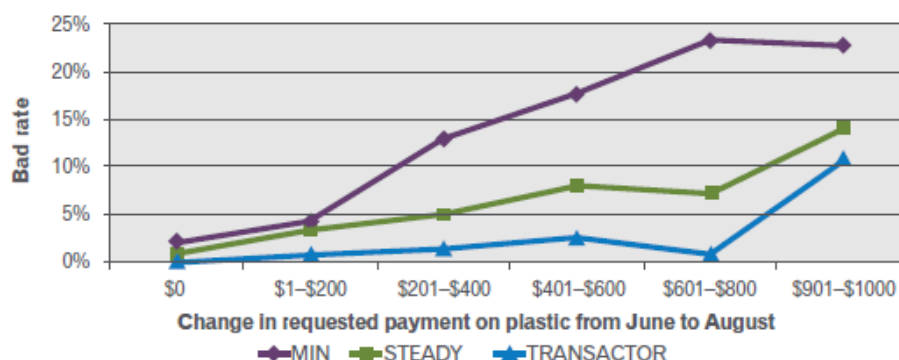
The chart below demonstrates a high correlation between the concentration of clients with revolving behavior in the portfolio versus the overall credit card Non-Performing Loans (NPL) ratio in the Brazilian financial system. Source: Brazilian Central Bank database.

Graph 6: Type of clients in credit card loan portfolios, percentage



In addition, Experian analysis on the payment history of consumers indicates that minimum payers (individuals who pay up to 5% of their balance) default more frequently than steady payers (individuals that pay between 5 and 99% of their balance) and transactors. See the chart below.

Graph 7: Payment history of credit card consumers

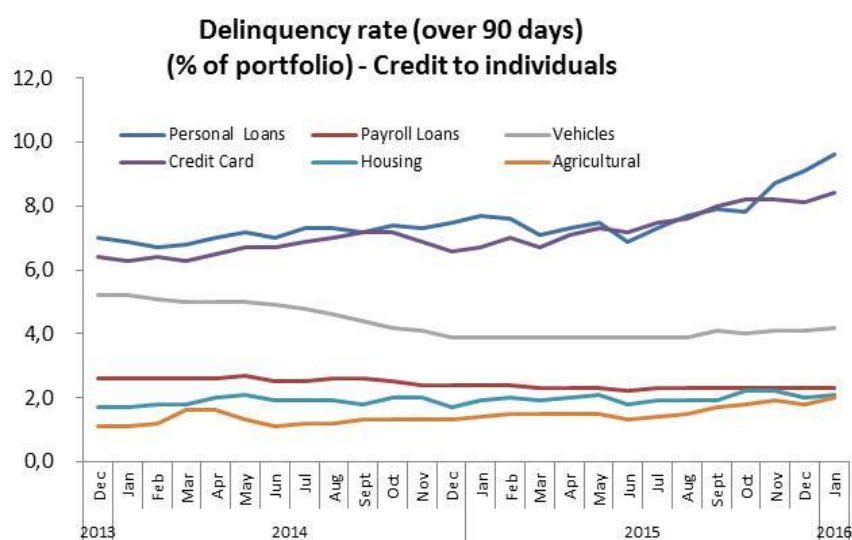


Source: <http://www.experian.com/assets/consumer-information/white-papers/6985-cis-ts-whitepaper-exp2014.pdf>

As seen above, customer behavior (transactor vs. revolver) and utilization-to-income rates are well correlated with default rates in revolving products, and could be used to differentiate the flat 75% risk weight applied to the Retail portfolio.

Finally, the proposal should differentiate the lower risk of some loans paid by receivables (e.g. commercial, service and credit card receivables, payroll payments, rents, long-term public concessions), collateralized by durable goods (e.g. vehicles, trade finance) and insured (e.g. rural). These loans have relatively lower default rates and, therefore, constitute important foment sources for SMEs and individual clients.

Historical performing data shows different NPL ratios for personal loans collateralized by payroll payments, vehicles and agricultural, compared with other personal loans.



Source: Brazilian Central Bank

9. Real estate exposures

In the draft standard, paragraphs 55 and 60, in cases where payment of the debt depends on the cash flows generated by real estate assets, in certain

circumstances risk weights could be higher than what the counterparty would receive if there were no real estate guarantee as such.

On this matter we wish to propose that, in the event that debt payment depends on cash flows produced by real estate assets, the maximum risk weight should correspond to that of the counterparty, as if there were no real property assets serving as guarantee.

On the other hand, and similarly to the 2014 consultative document, we understand the position of the BCBS in that exposures to the acquisition, promotion and construction of land (ADC) be risk weighted at 150%, as this finances exposures whose repayment is based on the future sale of the property (something uncertain), or on the generation of future cash flows that are equally uncertain. However, the proposed 150% risk weight is significantly high for banks that are more conservative in their ADC credit policies. For them, the SPV structure is extremely important as it ring-fences the project from financial instability or bankruptcy in the parent company. For instance, some banks release the largest part of contracted amounts only after the completion of project milestones, which is adequately assessed by banks and normally increases collateral value. Also, most banks use in their policies Loan-To-Value (LTV) ratio relative to total project cost instead of future market value, which means the loan may be under-collateralized only if market value becomes lower than project costs.

In addition, similar to the unrated Project Finance approach, we believe the Committee could consider applying a lower risk weight once the SPV demonstrates higher certainty on repayments, e.g. when a substantial volume of the property is sold or rented under contracts whose unilateral termination is subject to a penalty.

Thus, we propose turning the ADC treatment into a more risk sensitive approach, which could be made through the inclusion of metrics such as LTV and higher certainty on repayment.

Furthermore, the relatively lower risk of ADC financing for residential real estate would merit a lower risk weight than that applied to ADC financing for commercial real estate. This is a material issue because the proposed increase in risk weights for ADC financing for residential real estate would significantly impact the availability and cost of housing financing.

In turn it should be noted that the BCBS proposes that the value of the real property be kept constant in light of the LTV ratio, and suggests the possibility of making lower adjustments if the supervisor considers this to be relevant. We believe that this approach, albeit more conservative, is not linked to the capital requirement associated with these risk exposures. We believe that in principle there should be a *trade-off* between the more conservative measurement criterion and the risk weight coefficient to be applied.

In this regard it is pertinent to ask the BCBS to clarify this proposal. That is, an upward review of the commercial value of the real estate asset should be associated with a reduction of the LTV ratio and consequently of the risk weight assigned to said exposure (and vice versa).

10. Risk weight add-on for exposures involving currency mismatch

Differential treatment (higher penalization) for loans in US dollars. In this chapter, the new document (paragraphs 62 and 63) proposes a constant surcharge of +50% for foreign currency loans, with a 150% cap when it cannot be demonstrated that the customer can generate income in the same currency. This penalization applies equally to all exposure types (loans to companies, retailers and mortgages) regardless of the term established for the transaction, existence of collateral to cover the exposure, or any other consideration regarding the nature of the transaction.

Our understanding and interpretation regarding this matter lies in recent credit trends seen among the member nations of the Eurozone and countries in the European periphery that are not members of the Eurozone.

This being the state of affairs, in some cases there have been generalized loans in Euros in countries with currencies different from the Euro, so customers can benefit from the prevailing Eurozone low interest rates. This, however, has been done at the expense of customers facing significant currency risk in the event that local currencies devalue with respect to the euro, with the consequent negative results on their ability to repay its credit obligation.

While we understand the concern of the BCBS, we believe the proposal fails to take into account economies where loans are made in foreign currency (for example, in USD) in response to the greater extent to which those economies are dollarized, which in addition facilitates the existence of longer-term loans (this would be a case of many dollarized economies, such as for example Peru, Uruguay, Ecuador, El Salvador or Panama). For several macroeconomic or

cultural reasons, these countries, just to mention a few, have been handling this exchange rate exposure for decades, and this has nevertheless not given rise to generalized debt nonpayment issues or crisis.

In the event the Committee still considers it necessary to use an adjustment factor if there is a “currency mismatch,” we believe it would be more reasonable to use not an additive adjustment factor, but rather a multiplicative factor, such as for example the following:

$$RW_{(with\ currency\ mismatch)} = \alpha \cdot RW_{(without\ currency\ mismatch)}$$

In this way the penalty *add-on* would implicitly take into account some of the characteristics of the transaction, compared with the alternative of adding a weight risk of 50% evenly for all transactions regardless of their specific characteristics (type of counterparty, existence or not of collateral or guarantees, *LTV* levels, type of transaction, maturation, among other factors).

We further believe that this constant 50% *add-on* for currency mismatch is excessive. This because it does not take into account the specific characteristics of the operations that affect its inherent risk, such as for example the maturity or terms agreed, existence of collateral or guarantors, which should qualify the proposed adjustment. This type of foreign currency transactions would in fact be twice penalized: not only because of the capital requirements related to the credit risk, but also because of the additional requirements established by the technical recommendations of the BCBS regarding market risk, liquidity risk, counterparty risk, etc.

In Latin America in particular, foreign currency financing is used as a means to compensate for financial market deficiencies. For example, to overcome the difficulty (or even the impossibility) of longer-term financing in

local currency due to local regulatory restrictions. Or to conduct foreign trade transactions, structure operations in financial derivatives, or fund physical infrastructure projects.

For these reasons we believe this penalization should be qualified on the basis of counterparty type and terms/maturity. As an example, the risk involved in long-term exposures (set to 15, 20 or even more years) is not the same as in short-term company financing (of one year or even less than a year) in economies whether dollarized or not.

11. Off-Balance sheet positions

Elimination of the zero CCF (Credit Conversion Factor) for available unused credit card limits that are unilaterally cancelable

The BCBS is proposing a CCF of 10% or even 20%. In practice this means eliminating the 0% CCF in unused available credit limits (specifically credit cards with unconditional cancellation clauses in favor of the bank). There is concern in the sector with this idea of raising the CCF for available credit limits that may either be freely and unilaterally canceled or which include a clause contemplating automatic cancellation in the event of a deterioration in the solvency of the counterparty (paragraph 69).

According to FELABAN surveys of experts on the matter, the average use of available credit card limits in Latin America falls below 50%. In spite of this, the proposal implies increasing the capital provision to this effect by 10% to 20% over this portion of unused available credit limit.

Our estimates of economic capital include capital charges for unused credit card lines and provide us with numbers similar to those of current regulators. If we increase capital on the basis of unused lines without calibrating current RW, the regulatory capital in this product will exceed its economic capital.

By definition the proposal establishes a CCF of 10% to 20% for credit card limits not yet granted (that is, they are not credit yet) and which the bank can cancel before they are granted. In other words, the proposal intends to establish a credit risk charge for credits that do not yet exist. Besides, the liquidity regulation of the BIS (LCR) already requires provisioning for the possible use of these lines, and this would place additional pressure on these instruments and penalize them twice, if the Committee's proposal contained in the present section of the current consultative document were to be adopted.

Regarding this specific issue we suggest that this proposal be eliminated, maintaining the possibility that the CCF may be 0%. The impact produced by this modification would be highly significant for economies such as the Latin American economies. For example, such a credit risk charge would de-incentivize efforts towards financial inclusion by making the credit supply more expensive, precisely where financing by means of credit cards is relevant for both households and SMEs.

For Latin America in general and for the banks represented by FELABAN, attaining higher levels of financial inclusion is a long-term strategic objective. According to the World Bank, Latin American financial inclusion rates have grown between 2011 and 2014 and Latin America was the region with the highest growth for this indicator –rising from 38% to 51%--, an increase of 13 percentage points. Thus our region reached higher levels than those of South

Asia, and levels similar to those of Eastern Europe.⁴ Nevertheless, the gap with respect to Southeast Asia and the member nations of the OECD still marks the economic policy challenge that must be addressed in the coming years.

In addition, the Committee opted to maintain the 50% CCF applied to transaction-related contingent items, e.g. performance bonds, bid bonds, warrants and SBLCs related to particular transactions. In these transactions, CCF is supposed to reflect non-credit-related events, as counterparty's creditworthiness is reflected in the risk weights. However, the risk of a corporate in financial distress not performing a non-financial agreement related to its usual activities is quite lower than 50%. In the case of bid bonds, risk is even lower as it adds the chances that the bidder is not even selected for the project, which would finalize the bond without incurring in performance risk. Therefore, we believe the 50% CCF is overly conservative and suggest a revision to 20%.

12. Defaulted exposures

The Latin American banking sector believes that the initiative that considers the notions of "Defaulted Exposures" and "Past-due Exposures" as equivalent is well conceived, in that it improves the comparability and consistency of such exposures between the SA and IRB methods. However, we believe there is an opportunity to further improve alignment as described below.

Capital should only cover unexpected losses, which exclusively arise from LGD for defaulted exposures (the only uncertainty for a defaulted exposure remains in the LGD), i.e. differences between realized and expected recoveries on a portfolio basis.

⁴ <http://data.worldbank.org/products/data-books/little-data-book-on-financial-inclusion>

In the IRB framework, capital is required for defaulted exposures typically when downturn LGD (LGDDT) is higher than expected LGD (LGDE). Downturn LGD is only used for portfolios for which PD and LGD are positively correlated. This gives rise to a significant difference in scope of application of the capital charge for defaulted exposures between the SA and IRB, as IRB banks are frequently able to demonstrate that some of their portfolios (typically those with higher PD and LGD) do not exhibit positive correlation between PD and LGD. However, for SA banks, the correlation between PD and LGD is not taken into account and capital requirements for defaulted exposures are applied to the entire portfolio. As a result, SA banks are subject to much higher capital requirements for defaulted exposures than IRB banks.

When the RWs of 100% and 150% are converted into differences between expected and downturn LGDs, we arrive at the following table:

Expected LGD	20.0%	30.0%	40.0%	50.0%	60.0%	70.0%	80.0%
Downturn LGD (100% RW)	26.4%	35.6%	44.8%	54.0%	63.2%	72.4%	81.6%
Downturn LGD (150% RW)	29.6%	38.4%	47.2%	56.0%	64.8%	73.6%	82.4%

Given the loss experience accumulated since the risk weights for defaulted exposures were set over a decade ago, which includes data from severe crises in several jurisdictions, it should be possible to verify the calibration of the risk weights. It cannot be assumed that the 150% risk weight is adequate, especially considering the disparity of provisioning practices prevailing in the last decade and the fact that it was only applied to banks with relatively lower levels of provisions. For banks with adequate levels of provisions, a 150% RW may be too punitive unless the implied levels of difference between downturn LGD vs. expected LGD are supported by actual experience.

As the Committee is aware, provisioning practices are converging towards expected loss provisioning. IFRS 9 implementation, an important step in that convergence, will be finalized by 2018. Under that future accounting regime, provisions will likely cover the expected losses for defaults in the following 12 months, and in the lifetime of the exposure for the deteriorated parts of the portfolio. Provisions will also be forward looking, increasing when an economic downturn is expected.

However, important differences in provisioning practices still remain today, which call into question the convenience of changing capital requirements for defaulted exposures at this point, especially considering that the standardized approach does not have a mechanism for adjusting for differences between provisions and expected losses, as there exists in the IRB.

The importance of the link to provisions can be noted in the hypothetical example below:

	Bank 1 Provision = EL	Bank 2 Provision < EL
Exposure amount	100	100
Expected LGD	40%	40%
Downturn LGD	44.8%	44.8%
Expected Loss	40	40
Unexpected Loss	4.8	4,8
Provision	40	10
Net exposure	60	90
RWA (RW 100%)	60	90
Capital (RW 100%)	4.8	7.2
RWA (150%)	90	135
Capital (RW 150%)	7.2	10.8
Capital + provision (RW 100%)	44.8	17.2
Capital + provision (RW 150%)	47.2	20.8

Since convergence towards expected loss provisioning is a work in progress, current provisioning levels vary among banks. With a 100% risk weight, bank 1 is fully covered for losses, while bank 2 has a 62% shortfall. Increasing the risk weight to 150% unduly penalizes bank 1 while only reducing the shortfall of bank 2 to 54%.

For an adequate calibration, the total reserves (provisions + capital) constituted for the entire portfolio must be considered, and not only over defaulted exposures, as the fundamentals of provision and capital are nothing more but the total reserves required to absorb losses, and losses only occur in

defaulted exposures. Thus, the reserves that will support these losses (originated by defaulted exposures) are not only those linked directly to these defaulted operations, but the total reserves for the portfolio as a whole (i.e. capital and provisions for performing exposures cover the losses arisen from non-performing ones).

Additionally, given the way the proposal is currently designed, regulatory capital requirements will increase during stressed periods, creating undesired pro-cyclical capital treatment.

In summary, we propose to:

- **Revise the calibration of risk weights** for defaulted exposures under the standardized approach in order to achieve the desired proportion to IRB risk weights, taking into account actual IRB risk weights and the scope of application (i.e., exposure classes for which there is positive correlation between PD and LGD).

- **Temporarily retain the link to provisions** (i.e., lower risk weights for banks with high levels of provisions) until convergence to expected loss provisioning is further advanced. A revision of the 20% threshold may be necessary due to the change from past due to defaulted.

13. Credit risk mitigation

The Committee opted to maintain the text from Basel II Accord for funds eligible as financial collaterals, although we believe it is important to make a few updates. The text suggests that only funds "limited to investing in instruments

listed” are accepted, which excludes funds whose mandate does not prevent the manager from investing in non-eligible collaterals. Instead, we propose that the developments from BCBS’ “Capital requirements for banks’ equity investments in funds” be considered. In that sense, funds would be eligible as financial collateral up to the portion effectively invested in eligible collaterals (when using Look-Through Approach (LTA)) or, when look-through is not possible, to the minimum extent limited to invest in eligible collaterals under the fund’s mandate (Mandate-Based Approach (MBA)). The ineligible portion would be disregarded.

In the same way, even though the Simple Approach already defines the substitution for the weighted average risk weight applied to the fund under the framework (LTA or MBA), the Comprehensive Approach does not allow the MBA, suggesting instead the application of the highest haircut applicable under the mandate. For instance, when a funds’ mandate defines it must invest at least 80% in eligible sovereign bonds and the rest in equities listed on a recognized exchange, the haircut applied to the collateral will be 30%. Instead, we believe it would be more adequate to use a weighted average of the highest haircuts applicable under the mandate, which would be 18% ($15\% \times 80\% + 30\% \times [1 - 80\%]$). Therefore, when LTA is not possible, we propose that the Committee considers applying to funds under the Comprehensive Approach the weighted average of the highest haircuts applicable under the mandate.

14. Other comments

We believe fixed assets should not be regarded as assets subject to risk. Therefore a risk weight of 0% should apply to these types of assets, which are already contemplated under other BIS regulations regarding liquidity and leveraging. In other words, since fixed assets are not susceptible to credit risk, we believe a risk weight for them is unnecessary.

15. Final comments

In general terms we are unaware of the way in which the risk weight coefficients were calibrated, what jurisdictions were considered and therefore what they represent. This is clearly evidenced in thresholds and coefficients that notoriously acknowledge the concerns of developed economies (examples of this are the SME thresholds and currency mismatches, among others). On this matter, and without discussing specific issues in detail, we respectfully ask the Committee to clarify the way in which the proposed parameters were established, in general terms --countries analyzed, types of banks and financial institutions analyzed, sample periods used, etc.-- and, as a result, to clarify in what way such parameters include the realities of emerging economies. As an example, the case of regulations concerning liquidity illustrates the (practically) nonexistent adaptation of regulations conceived for developed economies and the attempt to apply them to emerging economies, when in fact these economies differ in a number of aspects. Just as the BCBS has systematically argued for greater disclosure of information on the part of banks, a greater degree of symmetry on the part of the BCBS seem to be fair, and would also provide for more constructive and enriching technical discussions regarding the regulatory and supervisory proposals issued by the BIS as they apply to emerging nations.

We consider fundamental that the impact measurements proposed by the BIS itself via the Quantitative Impact Studies (QIS) may shed the most light possible on the challenges this implies for banks, for the economy, for bank supervisors and for all actors concerned. Regarding this issue we believe that, since this analysis was done without knowing the respective results of the QIS for 2015, the possibility of performing deeper and more detailed analyses of the proposals contained in the Second Consultative Document is therefore restricted. We propose that the 2015 QIS results be published as soon as possible and that the possibility of holding a meeting to reveal and discuss them be considered, in order to enrich the analysis of this Second Consultative Document.