

Via Electronic Delivery

Co-Chairs, Task Force on Standardized Approaches
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2, Basel
CH-4002 Basel,
Switzerland

10th March 2016

Dear Sirs,

Fitch Ratings welcomes the opportunity to respond to the Basel Committee's second consultative document on revisions to the Standardised Approach for credit risk. Fitch believes the Committee's revised proposals represent a significant improvement over the initial consultation.

Credit ratings serve as important credit risk benchmarks for a variety of market participants. Fitch believes that the use of ratings as one input for the assessment of relative creditworthiness can support the Committee's goal of a stronger risk-based capital framework. It is important that market participants and regulators understand the strengths and limitations of ratings, and Fitch remains committed to assisting the Committee as it finalises its detailed proposals.

Fitch has also published a special report that considers some of the more detailed implications of the proposals, and which is included as part of this submission.

Yours sincerely,

Ian Linnell,

Global Analytical Head,
Fitch Ratings

Standardised Credit Risk – Evolution Over Revolution

Property Lending and Credit Cards Potentially Affected, Impact of Capital Floor Looms Special Report

This report assesses the Basel Committee on Banking Supervision's (BCBS) second consultative proposal to update the standardised approach to credit risk (SA), which was published in December 2015 following the release of the initial consultative proposal in December 2014.

Quick Reference Summary

Topics	Counterparty/Product	Jurisdic-tions
Use of Credit Ratings	Exposures to banks, specialised lending	All
Bank Ratings cannot use government support	Exposures to banks	M. East, APAC
Property Foreclosures	Real estate lending	ESP, PRT, ITA, GRC
BTL Mortgages	Residential real estate	GBR, NDL, DEU
Use of Original LTVs	Real estate lending	GBR, NDL
Unhedged FX Lending	Corporate, retail, mortgages	POL, AUT, TKY, PER, CRI, NIC
Off-balance-sheet CCFs	Unconditionally cancellable facilities, retail revolvers, short-term corporate facilities	US
Risk Mitigation	AAA-AA- debt, loans secured on equities/ stock borrow and lending, repo-style transactions	US

Amendment

This report, originally published on 9 March 2016, has been amended to update Figure 17 on page 9. All other content is as of the original publication date.

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Role of Credit Ratings Affirmed: The Basel Committee on Banking Supervision's (BCBS) revised standardised approach recognises the value of using credit ratings as a means for assessing relative credit risk for exposures to banks and corporates, alongside a new non-credit-ratings-based approach for the US. An implementation date hasn't been confirmed, but a quantitative impact study will be conducted in 2016 and the rules may be finalised by the end of the year. Assuming a two-year implementation period, the revisions may take effect by 1 January 2019.

Non-mechanistic Reliance on Ratings: Banks will have to undertake mandatory due diligence when using credit ratings for bank counterparties. This could lead to a bank assigning a risk weighting at least one bucket higher (but not lower) than the "base" risk weight.

Bank Ratings Exclude Support: Eligible credit ratings for banks must, under the proposals, be based on their intrinsic strength and exclude sovereign support. This equates to Fitch Ratings' Viability Ratings (VRs), which drive most US and Western European banks' Issuer Default Ratings (IDRs). But sovereign support drives many IDRs for Middle East and Asian banks.

Comparability Concerns: The non-credit-rating-based approach uses subjective criteria and applies a higher risk-weight floor than the credit-rating-based approach. Both require banks to apply due diligence that could increase risk weightings. These aspects may impair the consistency and comparability of capital-adequacy ratios across banks in different jurisdictions.

Time Limits on Property Foreclosures: Banks must demonstrate that property collateral for mortgages can be foreclosed within "a reasonable time frame" to avoid up to a threefold multiplication of capital charges. Some jurisdictions, such as Spain, Italy and Greece, have long foreclosure periods of up to eight years. Mortgages in these countries may not qualify for preferential real-estate risk-weightings without additional insolvency reforms taking place.

Buy-to-Let Mortgage Requirements Double: Proposals to increase risk weights for 60%-80% LTV buy-to-let (BTL) mortgages could double Pillar 1 standardised requirements for UK, Dutch and German BTL-portfolios, although some banks already hold additional Pillar 2 capital. Combined with the capital floor proposal banks' appetite for BTL business could reduce.

Proposals Could Encourage Refinancing: Proposals to capitalise mortgages based on original (rather than current) LTV are designed to avoid pro-cyclical risk-weights. During times of rising property prices, lenders may incentivise borrowers to refinance mortgage loans to reduce banks' capital requirements.

Credit Card Lines May Shrink: US banks may have to recognise capital charges on USD3trn of credit card facilities that do not require capital under the present standardised regime. This could lead to card issuers reducing undrawn credit lines.

Foreign Currency Lending Discouraged: Proposals for a risk-weight add-on for foreign-currency lending could raise minimum capital charges for unhedged foreign-currency loans. Some regulators have already demanded higher capital and/or conversion of these loans.

Risk Mitigation Changes: Changes to haircuts on highly rated non-sovereign securities under the non-credit-rating approach, and removal of internal models for derivative and repo products, could negatively affect US banks under the revised standardised credit risk regime.

Basel Credit Risk RWA Primer

- Banks are required to convert their credit risk balance sheet assets and claims to risk-weighted asset (RWA) equivalents, using either the regulatory prescribed “standardised approach” (SA), or the more risk-sensitive “internal ratings based” (IRB) model approach.
- Similar standardised or modelled capital calculation options are available for market and operational risks.
- The current SA credit-risk regime is supported by the use of external credit ratings that map to specified risk weightings (US substitutes credit ratings with OECD country risk classification scores).
- Under SA, off-balance-sheet claims (credit lines and other commitments) are converted to on-balance-sheet equivalent amounts using credit conversion factors (CCFs) that are weightings based on the propensity of the obligor to draw upon the lines of credit or commitments.
- The goal of the Basel Committee is to review and update all of the standardised approaches for credit, market and operational risks. These are being overhauled to improve their risk-sensitivity to represent a credible alternative to the use of internal model approaches.
- The proposed revisions to SA credit risk form part of a broader review of the Basel RWA framework initiated by the BCBS after the 2008 financial crisis.
- SA credit risk has not been updated by the Basel Committee since its introduction in June 2006, in contrast to changes to the IRB.

Summary of Consultative Proposals

Figure 1

Summary of Proposals

Exposure Class/Topic	Second consultation December 2015	First consultation December 2014	Current approach introduced June 2006	Capital Impact Positive (+) Negative (-)
Banks	Credit rating or constrained judgement ^a	CET1 and non-performing asset ratio	Either credit rating or sovereign rating	US Banks: High (-) EU Banks: Low/Med (-)
Corporates	Credit rating or flat risk weight approach (preferential for IG corporates) ^a	Revenue and leverage driven weightings	Credit rating or flat risk-weight approach	US Banks Med (+) for IG corporate treatment
Corporates	Specialised lending linked to corporate counterparty	Specialised lending linked to corporate counterparty	No specific specialised lending treatment	Negative impact (depending on business model)
Corporate SME	Preferential treatment for Corporate SME	No specific corporate SME treatment	No specific corporate SME treatment	EU banks: Med (-); Other Regions: High (+)
Residential real estate	Original LTV driving granular weights	Original LTV and debt service coverage driving granular weights	35% RW for “low” LTV (indexed values)	Depending on LTVs (+) for low LTV lending (-) for high LTV lending
Income producing real estate	Higher risk weighting for income-producing assets e.g. BTL mortgages	No specific treatment for income producing assets	No specific treatment for income producing assets	Banks with large BTL portfolios: High (-) e.g. UK, German, Dutch banks
Commercial real estate	Original LTV driving granular weights	LTV driven or unsecured risk weight approaches	Flat risk-weight approach	Depending on LTVs (+) for low LTV lending (-) for high LTV lending
Acquisition development construction lending	Flat risk weighting	No specific treatment	No specific treatment	Banks with substantial lending portfolio: High (-)
Foreign currency loans	50% risk weight add-on	No specific treatment	No specific treatment	Some CEE/LATAM Banks: Low/Med (-)
Equities/sub-debt	Higher flat risk weightings aligned to FI equities	Variable weights aligned to IRB risk weightings	Flat risk-weight approach	Banks with substantial equities portfolios: High (-)
Off-balance sheet items	General weightings >50%, no zero CCF	Aligned to F-IRB, no zero CCF weighting	Range of weightings from 0%-100%	Banks with large credit card portfolios: Med/High (-)
Credit risk mitigation	No internal exposure models/estimates, more granular haircuts. Higher equity haircuts New repo netting calc Retention of CDS w/o restructuring	No internal exposure models/estimates, more granular haircuts. Higher equity haircuts CDS w/o restructuring not deemed eligible protection	Internal exposure models, own estimates, reasonably granular haircuts. CDS w/o restructuring deemed eligible protection	US/EU/Japanese Banks (esp. securities subs): Med/High (-) US Custodian banks: Medium (+)

^a Standardised Credit Risk Assessment (SCRA) approach for jurisdictions that prohibit the use of credit ratings (e.g. US)
Source: Basel, Fitch

Revisions More Evolutionary, RWA Inflation Contained

Reduced Capital Impact

The first consultation proposals doubled the maximum risk weightings for bank and corporates exposure classes compared to risk weightings under the current framework. However, the second consultative proposals have made targeted changes to the real-estate, specialised lending, and SME lending areas, while leaving the risk-weighting treatment for bank and corporate exposures (under the credit-ratings-based approach) almost unchanged. For exposures to unrated banks (and for US banks), a new non-credit-ratings-based approach is proposed that applies judgement to bucket risk into one of three buckets (A, B and C), with a 50% risk-weight floor, compared with 20% under the present regime.

Related Research

[Changing the Standardised Approach: Alternative Proposals Must Demonstrate Predictive Power \(March 2015\)](#)

[Lower Losses Support Preferential Capital Treatment for STS Securitisations \(February 2016\)](#)

Related Criteria

[Global Bank Rating Criteria \(March 2015\)](#)

The risk weighting of equities represents a dramatic increase from current levels, but reduced compared to the prior proposals. A 50% risk-weight capital surcharge has been introduced for unhedged foreign-currency loans. Various changes have also been proposed for off-balance-sheet items and risk-mitigation framework that could impact banks with significant unconditionally cancellable credit lines, and derivative or repo portfolios.

Figure 2

Proposed Risk Weights

Exposure class	Second consultation December 2015	First consultation December 2014	Current framework Per June 2006 Accord
Banks: Long-term	Min: 20%, Max: 150% (Min 50% for SCRA ^a)	Min: 30%, Max: 300%	Min: 20%, Max: 150%
Banks: Short-term	Min: 20%, Max: 150%	Min: 30%, Max: 100%	Min: 20%, Max: 150%
Corporate	Min: 20%, Max: 150% (Min: 75%, Max: 100% for SCRA ^a)	Min: 60%, Max: 300%	Min: 20%, Max: 150%
Corporate- specialised lending	Min 20%, Max 150%	Min: 20%, Max: 150%	Not specified
Corporate- SME	Flat 85%	Not specified	Not specified
Retail/Retail SME	Flat 75%	Flat 75%	Flat 75%
Residential real estate	Min: 25%, Max: 150%	Min: 25%, Max 100%	Flat 35%
Commercial real estate	Min: 60%, cpty RW	Cpty RW or Min: 75%, Max: 120%	Min: 50%, flat 100%
Equity	250%	Min: 300%, Max: 400%	Min: 100%, Max: 150%
Sub-debt/other capital instruments	150%	250%	100%
FX-risk add-on	50%	Not specified	Not specified
Defaulted positions	Min: 100%, Max: 150%	Not specified	Min: 50%, Max: 150%
Other assets	100%, 0% cash in hand/gold, 20% cash in collection	100%	100% (option- 0% cash in hand/gold, 20% cash in collection)

^a Standardised Credit Risk Assessment (SCRA) approach for jurisdictions that prohibit the use of credit ratings (e.g. US)
Source: Basel

Capital Floor Widens Scope of SA

As it appears likely that Basel Committee will require banks using the internal model approaches (IMA) to calculate a capital floor based on the revised standardised approach (SA), the proposed changes are likely to affect all banks, not just those using the credit risk SA. Major US banks – those with consolidated assets greater or equal to USD250bn – are already held to the higher of risk-weighted assets (RWAs) calculated under the IMA and SA (refer to Figure 3 for the example of JP Morgan as at 1H15). The potential effect on individual banks from the Basel Committee's capital floor will be highly sensitive to its proposed Basel calibration and level of application.

There are likely to be two options proposed, requiring banks to hold the higher of the revised SA RWAs versus IMA RWAs – an aggregate bank-level floor, or at a risk-category floor for each of the major risk types (e.g. credit and market risk). The latter would likely be more significant for most IMA banks. But either measure is designed to limit the benefits of the IMA compared to the revised SA and place upwards pressure on portfolios with relatively lower IRB risk-weights – such as residential mortgage portfolios.

Use of Credit Ratings

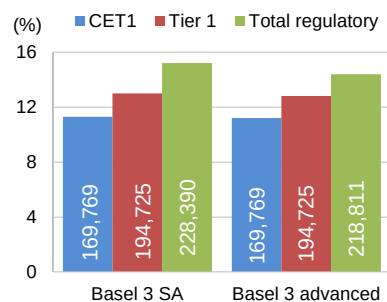
Reliable Credit Risk Benchmark

Fitch believes the revised proposals represent a significant improvement over the initial consultation. Fitch believes that credit ratings serve as important credit risk benchmarks for a variety of market participants. Credit ratings have been effective in assessing relative credit risk and are widely understood and accepted. Fitch supports the Committee's approach of accepting the use of ratings as one input for the assessment of relative creditworthiness in order to achieve a stronger risk-sensitive capital framework.

Figure 3

Example: JP Morgan - Transitional Capital Ratios

Standardised vs. Advanced (1H15)



Source: Company Pillar 3 disclosure, 1H15
Figures stated for absolute capital amounts in USDbn

Bank Credit Ratings

No Sovereign Support

The Basel Committee proposes that bank credit ratings must exclude government support to be used for the credit-ratings-based External Credit Risk Assessment (ECRA) approach. Banks can use credit ratings reflecting sovereign support for policy-type banks which are owned by their respective governments. There is no further requirement to strip institutional support from a bank's credit rating. The proposal will also eliminate the current Basel national option to hard-wire bank risk weighting to the domestic sovereign rating. Fitch also believes that an assessment of the potential for extraordinary sovereign support is an essential element of bank credit analysis.

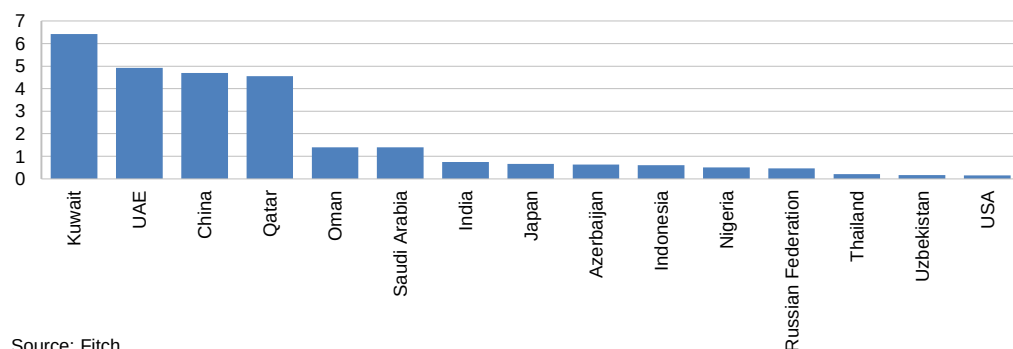
Fitch's Support Ratings (SRs) reflect our assessment of any support, which typically comes from either the bank's shareholders (institutional support) or from the national authorities of the country where the bank is based (sovereign support). The latter is also reflected in the Support Rating Floor (SRF). In assessing either institutional or sovereign support, Fitch considers both the ability and propensity of the potential supporter to provide assistance.

In May 2015, Fitch revised its sovereign-support assumptions for banks in North America, the EU, Switzerland, Norway and Hong Kong (see [Sovereign Support for European Banks: Bank Resolution Progress Lowers Likelihood of Sovereign Protection for Bondholders](#), dated 22 May 2015). This triggered Long-Term IDR downgrades of 46 EU banks and their subsidiaries. Fitch retains sovereign support as the basis for IDRs in some EU state-sponsored banks and many of the banks in the Middle East and Asia. The likelihood of an IDR based on sovereign support is maximised in countries where resolution legislation has not progressed significantly, with high sovereign ratings and where banks have low VRs (relative to the sovereign rating).

Figure 4

Sovereign Bank Support - Most Supportive Countries

By country, average notches between Support Rating Floor and VR (end-2015)

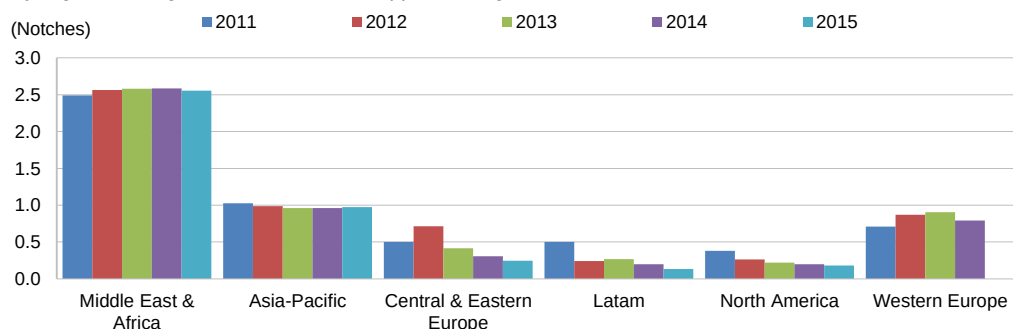


Source: Fitch

Figure 5

Notches of Sovereign Support

By region, average notches between Support Rating Floor and VR



Source: Fitch

Comparability Issues Remain

Under the revised SA proposals, two approaches are proposed for jurisdictions to implement. These options provide flexibility to national supervisors based on their prevailing legislative and supervisory preferences. But national options and discretions ultimately hinders the comparability of banks between jurisdictions. The ECRA credit-ratings-based approach is used in the present regime for the risk weighting of bank and corporate exposures. External credit ratings issued by nationally approved credit ratings agencies are mapped to five risk-weight buckets. The ECRA is used by a significant majority of the 27 BCBS members. For jurisdictions where banks are prohibited from using credit ratings for regulatory risk weighting purposes, for example, the US, the Basel Committee proposes a new non-credit-rating-based Standardised Credit Risk Assessment (SCRA) approach. The SCRA buckets bank exposures into one of three grades, and corporate exposures into one of two categories, with varying risk weightings.

Albeit undefined within the proposed revised hierarchy, national jurisdictions may choose to apply flat risk weightings based on other characteristics not defined by the Basel Committee, for example, Brazil, where flat risk weightings apply to bank exposures depending on maturity, and corporate risk weights are set at either 100% or 85% depending on the type of entity.

Due Diligence Required

Both the ECRA and SCRA methodologies require banks to conduct internal due diligence on the risk profile of bank counterparties before using supervisory risk weightings. Banks are permitted to classify their counterparties to a higher risk-weighting bucket (but not lower bucket) where their due-diligence analysis reflects higher risk characteristics than implied by the supervisory risk-weight bucket. However, such flexibility will inevitably hinder comparability between banks (unless bank disclosures are expanded to indicate where more penal risk weighting choices were made, based on internal due diligence).

The SCRA applies a 50% risk weight (RW) floor whereas the ECRA applies a 20% RW floor for banks with Fitch VRs between 'aaa' and 'aa-'. Notwithstanding the relatively small number of bank issuers that carry such high ratings (39 banks as at 31 January 2016), disparity could emerge between banks in regions that apply SCRA (US banks with more than USD500m in assets or the largest bank holding companies subject to SA credit risk floor under the Dodd Frank Act) and banks in jurisdictions that use the ECRA, for example, EU banks.

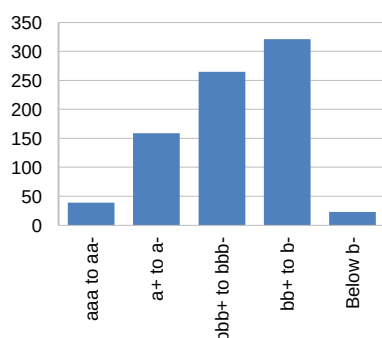
Extra Impact for US Banks

The effect of moving to the proposed SCRA bank exposure regime with a 50% RW floor would be amplified for US banks, due to the US SA regime setting a flat 20% RW for all exposures to US banks. This would mean RWs more than doubling for US banks with exposure to US peers, if the second consultative proposals are adopted by the US regulatory agencies.

Banks subject to SCRA have to apply securities collateral haircuts twice as high as haircuts under ECRA for the highest quality (AAA to AA-) non-sovereign-debt securities (2% under SCRA, versus 1% under ECRA). The SCRA collateral haircut levels noted also represent an increase from current supervisory haircuts under Basel III. The proposed higher SCRA collateral haircuts could disadvantage US banks versus their EU peers, as a US bank will require 2% of overcollateralisation on a reverse-repo over AA-rated corporate debt to eliminate counterparty credit risk charges, whereas EU banks will continue to benefit from current haircut rules for the same debt security and require just 1% overcollateralisation to benefit from zero counterparty credit risk charges on the same reverse-repo transaction. But Fitch believes that higher SCRA overcollateralisation levels may not affect banks' requirements significantly. Based on US industry estimates¹, repo transactions over corporate securities are generally collateralised at between 5-8% (versus US treasuries repo overcollateralisation levels of 2%). This could suggest that, at least in the US market, the higher SCRA haircut requirements are already met for some corporate securities-based repo transactions.

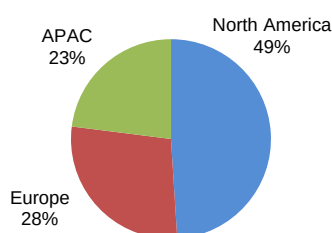
¹ Securities Industry and Financial Markets Association (SIFMA), data as at January 2016.

Figure 6
Bank Issuers by Fitch VR



Source: Fitch, as at 31 Jan 16

Figure 7
Geographic Breakdown of Bank VRs
aaa to aa-



Source: Fitch, data as at 31 Jan 2016

Real-Estate Exposures

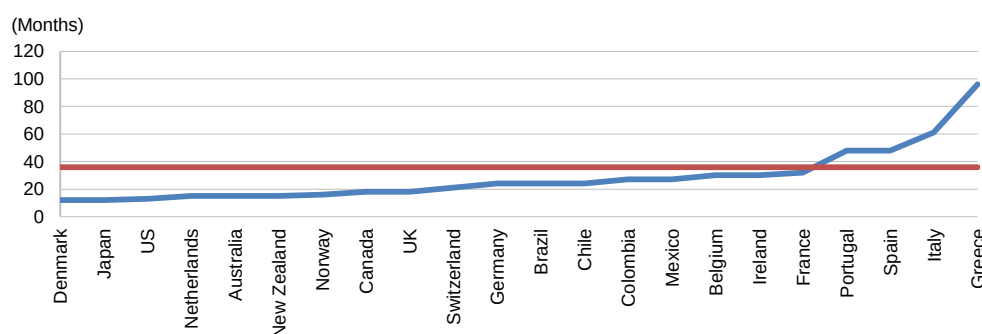
Property Foreclosure

As part of a general overhaul of legal and prudent underwriting criteria pertaining to real-estate lending², the Basel Committee proposes more detailed legal criteria underpinning the eligibility of property collateral. Specifically, the committee proposes that banks must be able to realise the value of the property “within a reasonable time frame”. Should a real-estate loan fail to meet this legal criterion (or prudent underwriting criteria), elevated “non-compliant” RWs shall apply of 100% for owner-occupied residential mortgages, 150% for BTL mortgages and 100% to 150% RW for commercial property loans.

However, timelines for the foreclosure or liquidation of real estate can vary significantly based on the relative efficiency of the jurisdictional processes between countries, and sometimes between administrative regions of a country, for example, between northern and southern Italy. Timelines within US states may also vary significantly due to the use of power of sale against judicial frameworks. Varying timescales for foreclosure also reflect enhanced consumer-protection arrangements.

Figure 8

Global Residential Foreclosure Timelines



Source: Fitch estimates

Particularly noteworthy are the disparate foreclosure timelines between EU regions, reflecting differing insolvency practices (and legal inefficiencies) across the region³. For a cohort of “northern” EU jurisdictions – Denmark, the Netherlands, the UK, Germany – Fitch estimates typical residential foreclosure timelines of one to two years. In contrast, Fitch estimates it can take between four and five years to achieve foreclosure for residential properties in Portugal, Spain and Italy. In Greece, thanks to recent legislative changes to protect homeowners, residential foreclosure is estimated to take up to eight years.

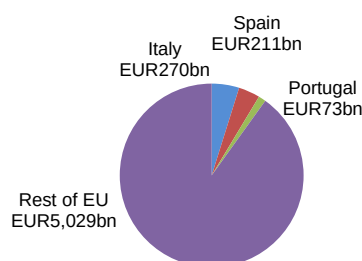
Based on this significant variation within the EU, a question arises as to whether a common “reasonable” timeframe will be defined in line with the spirit of the “maximum harmonization” single rulebook. Even a relatively long timeframe by international standards of 36 months could disqualify Portuguese, Spanish, Italian and Greek residential mortgages from the preferential risk weightings. This could lead to a flat 100% RW for owner-occupied mortgages (150% RW for BTL mortgages) or up to a 150% RW for commercial real-estate loans. However, the European Commission is working on a set of common insolvency principles to improve the efficiency and effectiveness of insolvency regimes within member states, which could improve alignment of insolvency timelines. In Italy, a draft law is being discussed that would give banks

² Real-estate lending is defined as an exposure secured by an immovable property. This would normally not include foreclosed properties, which would generally be regarded as fixed assets held directly on the balance sheet.

³ Estimates sourced from Fitch Structured Finance criteria “base” assumptions for the regions noted. The assumptions are derived from the loan-level repossession data and information supplied by servicers during the rating process. The foreclosure timeline assumptions may not reflect actual foreclosure timelines, which will vary according to circumstance.

Figure 9

EU Real-Estate Exposures



Source: EBA Transparency Review 2015- SA and IRB Real Estate Exposure Amounts by borrower jurisdiction (Greek banks absent from sample), Fitch

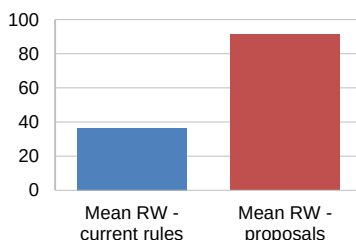
Figure 10
Example Calculation

GBP100k BTL mortgage for GBP150k property (LTV 67%)
Current RWA: GBP100k * 35% (RW: LTV ≤80%)
= GBP35k RWA/GBP3.5k CET1 @10% CET1 ratio
Proposed RWA: GBP100k * 90% (RW: 60% < LTV ≤80%)
= GBP90k RWA/GBP9k CET1 @10% CET1 ratio

Source: Fitch

Figure 11
BTL RWA Impact: Select UK Building Societies and Banks

(Risk weighting, %)



Source: Fitch estimates

the right to repossess without having to proceed through the court process, which could shorten Italian foreclosure timelines.

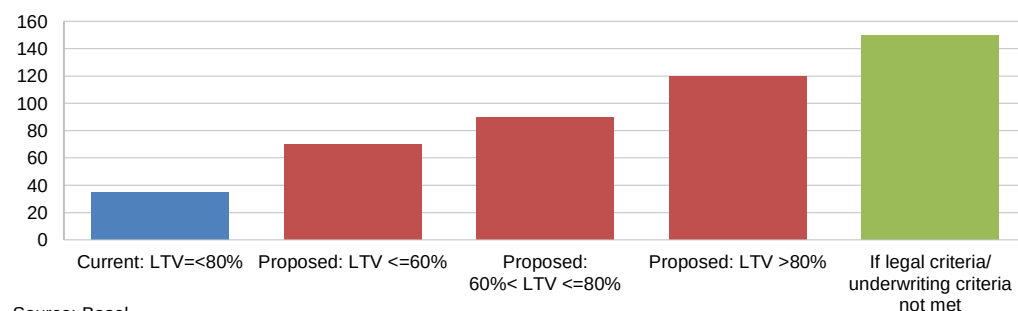
Buy-to-Let Mortgages Affected

All exposures fully secured on residential real-estate collateral attract a 35% RW (the EU regards “fully secured” as up to 80% LTV), irrespective of whether repayment is materially dependent on cash flows generated by the property or for speculative development purposes. However, jurisdictional implementation of the Basel regime also considers other criteria, including loan-to-income restrictions and LTV caps, such as those being considered by the Bank of England’s Financial Policy Committee.

The Basel Committee proposes that banks hold higher capital charges for mortgages where the repayment of the loan is materially dependent on the cash flows generated by the property (including BTL mortgages) and for speculative development loans where the source of such repayment is uncertain.

Figure 12
Risk Weightings: Residential Buy-to-Let Exposures
Repayment is materially dependent on cash flows generated by property

(Risk weighting, %)



Source: Basel

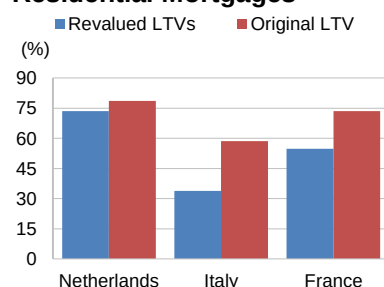
For BTL residential mortgages of between 60% and 80% LTV (collateral value as at origination), the risk weighting would almost triple to 90%, whereas mortgages in excess of 80% LTV will be subject to a risk weighting of 120% (see Figure 10 for an example calculation for a typical UK BTL mortgage). The Basel Committee says this is to account for higher risk, due to stronger positive correlation between the prospects for repayment of the exposure and the prospects for recovery in the event of a default.

Fitch assessed the potential impact of the proposed risk-weighting rules on several UK building societies and smaller banks that are active in BTL loans and that calculate RWAs using SA credit risk (see Figure 11). For these institutions, average RWs for their BTL portfolios would increase to 91% from 36%, leading to an average increase in BTL mortgage RWAs of about 150%. Fitch estimates that 26 percentage points of the increase is due to the use of LTV at origination for the proposed calculation methodology as the use of indexed LTVs is estimated to lead to an increase of 124% in RWAs for the BTL mortgage portfolios reviewed.

While the majority of UK banks that engage in BTL lending use the IRB approach to credit risk, these institutions have to consider the implications of the impending capital floor that would apply to the revised SA RWs. Prime BTL portfolios that benefit from very low average IRB RWs (sometimes below 10%) would be required to be risk weighted at a minimum 70% under the proposals, if the capital floor applied at the BTL portfolio level. Assessing the impact of this capital floor assumption on a broader range of small UK banks and larger building societies that use IRB models, average RWs for their BTL portfolios calculated under the proposed weightings would see average RWs increase from 35% to 82% (i.e. an increase of 135%).

Figure 13

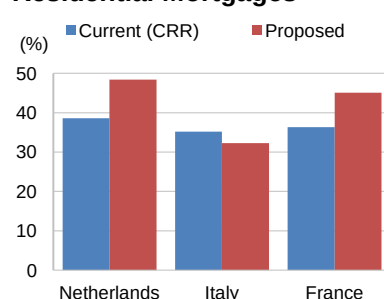
**Weighted Average LTVs:
Owner-Occupied
Residential Mortgages**



Source: Edwin, Fitch

Figure 14

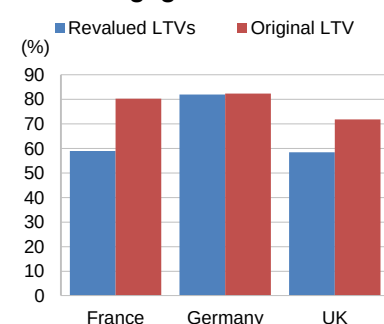
**Weighted Average RWs:
Owner-Occupied
Residential Mortgages**



Source: Edwin, Fitch

Figure 15

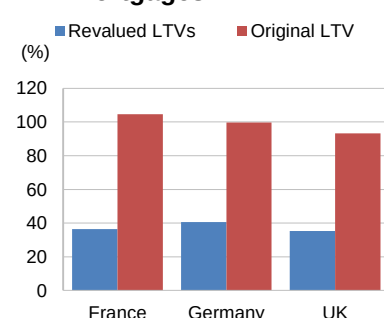
**Weighted Average LTVs:
BTL Mortgages**



Source: Edwin, Fitch

Figure 16

**Weighted Average RWs:
BTL Mortgages**



Source: Edwin, Fitch

Fitch conducted an analysis on 3.8 million BTL mortgages, using loan-level records from transactions since 2012 available from the European Data Warehouse (Edwin) to get an indication of the impact that the new proposals would have. The Edwin data are made available by the ECB as part of its repo operations and contain information on all loans included in securitisations placed with it. Dutch owner-occupied residential mortgages were the most leveraged within the EU sample, with average weighted LTV of about 74% when using current property prices, in contrast to Italian residential mortgages, which had the lowest average weighted LTVs of just 34% when using current property valuations (see Figure 13).

When using original property values, the proposed owner-occupied residential risk weightings led to a reduction in RWs for Italian mortgages (see Figure 14), although Italian owner-occupied mortgages appeared to be most sensitive to increases in LTV, with average weighted LTVs increasing 73% to about 59% LTV. Whereas Dutch, French (and German) mortgage weighted average RWs would increase under the Basel proposals. We noted a similar RW increase under the proposed use of LTV at origination for French and German BTL mortgages as for the UK BTL portfolios (see Figure 16). We believe that the small LTV variation for German mortgages (at origination versus revalued/reindexed mortgages) were due to the sample underlying mortgages comprising recent lending activity, that were subsequently securitised.

Meanwhile, loans for speculative land acquisition or property construction and development, will be subject to a 150% risk weighting, compared with 100% now.

Extra Pillar 1 Capital Required

These risk-weight increases will require banks with large residential BTL and development loan portfolios to greatly increase the amount of Pillar 1 capital that they hold for these portfolios or to reduce capital surpluses over minimum authorization requirements. Alternatively, banks may reduce lending to this business line due to the much higher cost of carry or sell higher LTV at origination portfolios to non-bank entities.

However, Fitch believes there may be some dilution of additional charges, as bank supervisors usually require banks with such portfolio concentrations to hold additional capital under the Pillar 2 Supervisory Review and Evaluation Process (SREP), specifically to account for the higher risks noted by the Basel Committee. Should bank supervisors conclude that these revised standardised RWs for real-estate lending better reflects risks presently capitalised under the SREP, then banks may be allowed to reduce their Pillar 2 capital add-ons for BTL and development property loans, as and when the applicable Pillar 1 capital requirements increase. However, institutions may still require additional regulatory capital, if the Pillar 2 buffer does not adequately capture the potential Pillar 1 RWA inflation.

Product Pricing Implications

To dampen the effect of cyclicity in housing values, the Basel Committee maintained its original proposal to calculate mortgage LTV based on the value of the property at origination. The impact on pricing and borrower behaviour could depend largely on the type of mortgage lending that takes place and the tenor of mortgages to which redemption fees apply.

Fitch conducted an analysis on 136 million loan-level records using the Edwin data set to get an indication of the impact of the new proposals. In the Netherlands, where borrower tax incentives may encourage mortgage loan originations at high LTVs, we see risk weightings for residential mortgages generally increase under the new proposals (see Figures 15 and 16). Banks in countries with lower LTV mortgage lending, such as Italy, may benefit under the Basel proposals for lower risk weighting at thresholds below 60% LTV (25% or 30% RW, versus the current 35% RW applicable under the EU's implementation of Basel III).

Fitch believes the reduced risk weighting applicable when banks lend at 40% LTV or less (25% risk weight against 35% now) could spur the issuance of mortgage products benefitting from

lower rates or fees at this LTV threshold. Otherwise, we do not foresee many changes in such markets as mortgage risk weighting in the 60-80% LTV range remain unchanged.

Shorter-Term Fixed Rates May Be Favoured

However, the use of original LTVs, together with an inability to reprice the property collateral during the tenor of the mortgage, could lead to mortgage lenders selling products with shorter-term lock-in tenors in jurisdictions with higher LTV lending. This would be done to motivate borrowers to redeem mortgages relatively quickly and benefit from revaluing property collateral during an economic upcycle. Provided mortgage lenders price new mortgage products at a more attractive level, borrowers may opt for the reduced security of shorter fixed or capped rates.

In such markets as France, Germany and Spain, where mortgages tend to be fixed or capped for extended periods, the use of original LTV could lead to mortgage lenders inadvertently holding more capital over time than such markets as the UK, where the market is more geared towards shorter fixed or capped periods. This could result in the unintended consequence of banks being less willing to offer long-term fixed-rate mortgages, which could expose borrowers to considerable interest-rate risk and make the mortgage product riskier to the consumer. Banks may also be incentivised to price BTL repayment mortgages more favourably than interest-only options, due to the reduction in mortgage principal over time, which could reduce capital charges.

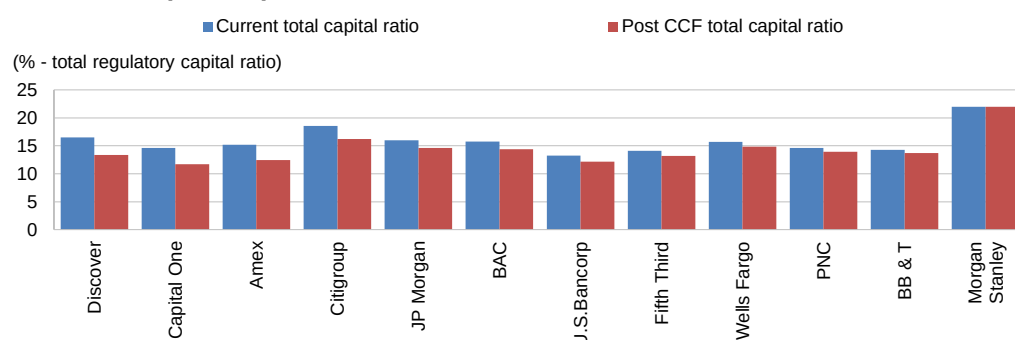
To mitigate potentially higher capital charges, banks may sell select mortgage loans to reduce both their solvency and leverage ratio capital needs (while retaining servicing rights to earn a fee on the mortgages originated). Alternatively or alongside whole loan sales, banks may be incentivised to package and securitise more-seasoned mortgage loans to optimise balance sheet asset usage alongside delivering RWA capital relief. The creation of securitisation programmes that meet the forthcoming Simple Transparent and Comparable Basel (and comparable EU) securitisation regime could provide banks with a preferential route to originate such securitisations while minimising capital held on any retained tranches (as some securitised assets must be retained to meet “skin-in-the-game” rules).

Borrower Credit Facilities

The proposed credit conversion factor (CCF) changes will increase risk weighted exposures, particularly for the 0% weighted non-retail “unconditionally cancellable” facilities that are proposed to be subject to 50-75% CCF. However, Fitch believes that significant increases in exposure values for corporate facilities are less likely. We assume that negative reputational and relationship implications may limit bank’ granting corporate borrower facilities that can be cancelled at any time without notification. Unconditionally cancellable retail facilities – credit cards and personal overdraft products – will continue to be weighted at a preferential CCF ranging between 10% and 20%. For banks with significant types of these facilities, however, the preferential weightings may still lead to negative capital charge implications under credit risk SA.

Figure 17

Potential Capital Impact of Non-Zero CCFs for Select US Banks, End 2015



Source: Company Financial Statements as at year-end 2015, Fitch calculations (assuming 10% CCF for retail UCC, 50% CCF for non-retail UCC, retail UCC risk weighted at 100% as per current US Basel III regime, rather than using the proposed BCBS 75% retail risk weighting)

For large US institutions, (particularly large credit card issuers), unconditionally cancellable lines of credit (UCC) are material. Under US rules, internationally active bank holding companies are subject to a 100% SA-based capital floor on their IRB capital requirements. As at end-2015, UCC totalling about USD3trn were subject to an SA 0% CCF for a select range of the largest bank holding companies and credit card issuers (based on company regulatory disclosures). Consequently, if the US regulatory agencies were to adopt the Basel Committee's CCF changes in their SA, these groups could require significantly more capital.

Assuming a 10% CCF would apply to retail UCC (and 50% CCF applies to non-retail UCC⁴), some credit card issuers would see their total regulatory capital ratios decline by over 3%. The large US universal bank holding companies would be less significantly affected, but would still see their total capital ratios fall by almost 1% were a 10% CCF apply to retail UCC.

Were such proposals adopted by the US regulatory agencies, Fitch believes affected firms could act by reducing unused credit lines, similar to what occurred after the financial crisis, when credit card issuers aggressively reduced unused lines.

Banks in the EU are not currently subject to a 100% capital floor as in the US, and the IRB approach is often used for credit card exposures. For those exposures whose risk weights are calculated using SA, the use of the 0% CCF for UCC does not appear widespread. Based on a Fitch review of 105 medium-to-large EU banks as at end-1H15, only a few individual German, Dutch, Finnish, and UK banks appear to benefit significantly from the application of the SA 0% unconditionally cancellable CCF for retail (and retail SME) customers, in a similar manner to that noted for the US banks above. Generally, it appears that average CCFs used across corporate, retail and SMEs are above 50%, reflecting a mixture of the 50% longer-tenor CCFs, alongside the use of 20% CCFs and 100% CCFs for "full-risk" items.

Figure 18

Implied SA Credit Conversion Factors for Select Banks Within Certain EU Countries

As at 1H 2015 based on current CRR framework



Source: EBA Transparency Review 2015, as at 1H15, Fitch

Foreign-Currency Lending

Unhedged Lending Key

The Basel Committee has proposed a 50% RW add-on⁵ for corporate, retail, and real-estate loans where the lending currency differs from the currency of a borrower's main source of income. The proposal notes the surcharge does not apply if the borrower receives matching foreign-currency (FC) income or if the loan is hedged by the borrower with a foreign-exchange derivative. However, the wording used in the proposed rule is unclear, with no thresholds cited for the adequacy of matching FC income versus principal or interest repayments under the FC loan to be deemed hedged.

⁴ Based on Fitch estimates of the proportion of the non-retail UCC component in relation to the overall UCC amounts, for the US banks assessed

⁵ It is unclear whether the proposal is a flat 50-percentage-point add-on to the base risk weight or an add-on of 50% of the applicable exposure class risk weight.

Where FC commercial property transactions (including income producing real estate) have income flows from rental and sale proceeds that match the purchase and loan currency denomination – as the majority of such transactions are – they may be regarded as naturally hedged (noting earlier uncertainties regarding definition). Consequently, Fitch's view is that unsecured FC corporate and commercial borrowings, along with FC retail and residential mortgage loans, are most vulnerable to the foreign-currency RW surcharge.

Reduced Risk in Hungarian Banks

Credit risks in Hungarian banks' retail portfolios have significantly reduced following the conversion of FC residential mortgages into the local currency, and smaller monthly loan instalments (the latter being driven by the Act on Settlements and new rules on loan pricing). Fitch believes that in jurisdictions most affected by unhedged FC lending practices, regulatory authorities require banks to hold regulatory capital far in excess of the current Basel guidelines, or require risk buffers to be maintained under Pillar 2 SREP. So while Fitch believes the RW surcharge will discourage banks from engaging in FC lending (or at least hold greater capital commensurate to the heightened risk), the proposed additional minimum capital requirement is unlikely to significantly raise overall capital needs in EU jurisdictions most affected by unhedged FC lending.

Austria Foreign Currency Loans Significant

In terms of Fitch's CEE-rated universe, we view Austrian banks as potentially vulnerable to FC-based capital charges on an indirect basis, via the proposed capital floor for IMA. Austrian lenders apply IRB models for the bulk of their retail and residential mortgage portfolios. At end-1H15, the overall Austrian banking sector had EUR25.2bn of Swiss franc-denominated loans to private households in Austria, comprising about 11% of gross loans, entirely unhedged. Over 95% of all domestic FC retail loans in Austria are in Swiss francs (the remainder is mostly in yen). Due to the corresponding higher risks posed by their FC retail lending, the Austrian bank's subsidiaries' Swiss franc-denominated CEE loan portfolios are subject to relatively high RWAs, which comfortably exceed the average for large western European banks.

While some rated Polish banks do have significant legacy FC retail mortgage exposures and are mostly subject to the SA (on a standalone unconsolidated basis), they generally extend FC mortgages only if natural hedges are in place. Additionally, the Polish FSA requires FC mortgages to be risk-weighted at 100% under SA, and substantial FC risk buffers are required of the banks with large FC mortgage portfolios – a median 5.5% capital charge as a percentage of gross FC lending as at end-2014. Consequently, Fitch's view is that Polish banks are adequately capitalized to cushion their FC risks (absent a forced conversion of FC mortgages to local currency at exchange rates much below market rates).

Fitch-rated Russian banks have insignificant FC retail and residential mortgage lending due to their penal risk-weighting regime (FC unsecured retail loans attract RWs up to 600%, and FC mortgages receive up to 150% RWs). While rated Bulgarian banks' euro-denominated loans comprise a median 10.5% of gross loans, this risk is mitigated by the Bulgarian lev/euro currency peg together with a currency board arrangement. Romanian FC lenders in turn benefit from a sovereign guarantee over their "Prima Casa" FC mortgages, which helps mitigate their FC risk and results in low blended RW for these state-guaranteed mortgages.

Significant Risks in Turkish Banking Sector

FC risks are significant in the Turkish banking sector, where 32% of total sector loans were denominated in foreign currencies, almost solely comprising corporate and commercial loans. These loans are often made to companies without direct FX export revenues. However, risks are mitigated by the fact that the exposures are frequently to prime corporates that have well-diversified revenues. Some FC borrowers are hedged on a short-term basis. As Turkey risk-weights foreign-currency loans no differently than loans to the same counterparties in the local currency, there is scope for Turkish bank RWAs to increase should the 50% risk-weight surcharge be implemented.

Fitch does not view FC risks as significant elsewhere in the Middle East, Africa, and Far East Asia (with the exception of Mongolia). In Latin America, unhedged FC lending is fairly uncommon, usually only comprising a small fraction of total loans and being heavily concentrated on corporate and commercial loans. The only concerning countries in this regard are Peru, Costa Rica and Nicaragua, where FC retail lending is widespread. Nicaragua is most affected by “dollarization”, as local currency-denominated loans are usually linked to the dollar.

Credit Risk Mitigation

Securities Firms Affected

The Basel Committee retained its initial consultative proposal to eliminate the use of the Internal Model Method (IMM, used for derivatives⁶) or Repo-VaR method⁷ (for repo-style transactions), where institutions do not have approval to use the IRB approach for credit risk. Broker-dealers and custodian banks are most likely to use the standardized approach for credit risk while having approval to use either IMM or Repo-VaR for exposure calculation of traded products. Typically these companies have very little lending business for which it would be difficult to justify investment in the IRB approach.

In general, the elimination of the internal approaches noted would increase exposure amounts for institutions that have implemented, or are seeking to implement, such models for regulatory minimum capital requirements. Importantly, these changes would not increase exposure amounts calculated under the leverage ratio. Therefore, the relative impact of these proposals depends to a large degree on whether the affected institutions are constrained by solvency ratios or by leverage ratios.

For derivative exposure estimation, affected institutions will instead be required to use the (already finalised) standardised approach to counterparty credit risk (SA-CCR, due to be implemented by 1 January 2017). While the SA-CCR is more risk-sensitive than the current exposure method it replaces (also known as the mark-to-market method), it is viewed by the industry as less sensitive than the IMM. Accordingly, the elimination of the IMM is expected to drive up exposure amounts for derivatives-trading portfolios and increase minimum capital requirements.

For institutions that estimate haircuts for repo-style transactions using the Repo-VaR method, the use of supervisory haircuts could also increase exposure RWA exposures. There are two main drivers for this. Firstly, the Repo-VaR model is more risk sensitive and consequently applies lower haircuts on high-quality and liquid collateral items compared to the supervisory haircut method. Secondly, the Repo-VaR model allows banks to recognise all trading book instruments and positions as eligible financial collateral, so reducing repo exposure RWAs when receiving (for example) lower credit quality bond securities. In contrast, under the supervisory haircut approach, recognised eligible collateral is much narrower, for example, appropriately rated debt securities, cash, listed equities and gold.

While the Repo-VaR method is a more risk-sensitive way to judge haircuts for repos in a netting set, both the current and proposed Basel regimes allow institutions to assign repos to the regulatory trading book to use a much broader range of collateral to offset the applicable counterparty credit risk charge. Institutions in Europe (and in some other jurisdictions) can therefore mitigate against the removal of the Repo-VaR by assigning repos to their trading books (where the transactions meet trading book assignment criteria) to continue benefitting from applying a broader range of collateral against their repo counterparty exposure.

⁶ The IMM consists of several component models to compute a regulatory estimate of counterparty credit risk exposure.

⁷ Also referred to as the master netting agreement internal models approach. This approach uses the banks' regulatory Value at Risk (market risk) model to calculate potential price volatility for repo-style transactions within bilateral netting agreements. The Repo-VaR is an alternative to using the supervisory volatility adjustments approach or the own-estimates of volatility adjustments approach, in calculating volatility adjustments.

US Banks Affected by Removal of Repo-VaR

But US bank holding companies (and their respective broker-dealer subsidiaries) are prohibited from assigning repos to the trading book as their interpretation of the trading book boundary does not recognise repos as trading book positions. Assuming the US regulator maintains its stance of excluding repo-style transactions from the regulatory trading book, the elimination of the Repo-VaR method could put broker-dealer subsidiaries of bank holding companies without IRB permission at a relative disadvantage to similar EU banks. Were this proposal to be implemented by the US regulator, it could lead to repo exposure RWAs increasing for the larger US bank holding companies that are subject to a permanent SA capital floor, such as custody banks.

Perhaps to soften the blow from the removal of the Repo-VaR, the Basel Committee proposes to update the repo master netting calculation to better reflect netting and diversification benefits for repos in a bilateral netting set⁸. Across an estimated portfolio comprising five repo transactions involving a combination of 'BB+' and 'AA-' rated securities, Fitch observed the use of the new methodology led to a 40% drop in exposure levels versus the current master netting agreement.

The Basel Committee maintained its proposal to increase equity collateral haircuts under the collateral comprehensive approach. Assuming collateralisation levels remain "as-is", higher collateral haircuts will increase counterparty credit risk exposure levels and thus RWA, for repo-style, margin lending (including Lombard lending) and derivative transactions that are collateralised with equities. We note that the equities haircut levels have risen more than capital-market transactions collateralised with other eligible collateral items such as debt securities. Institutions that wish to avoid higher exposures will consequently seek more collateral from their trading counterparties or borrowers.

Repo Haircut Floors Target Shadow Banks

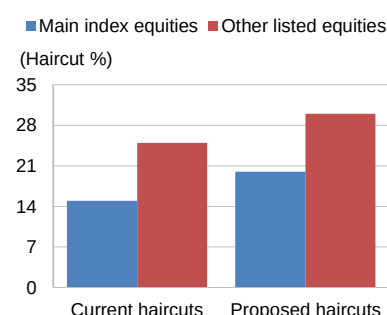
The second consultative proposals include a placeholder for a separate Basel reform to apply haircut floors to repo transactions between banks and non-bank entities that are not centrally cleared⁹. If affected repos are not sufficiently overcollateralised, banks would have to risk-weight the transaction as if it were fully uncollateralised, which could significantly increase trade exposure and thus RWAs. For repos within a netting set, the required overcollateralisation amounts are proposed to be computed using a complex formula. This methodology appears to be computationally intensive and banks could find it difficult to implement and apply on a trade by trade basis.

However, some transactions are exempted, including repos backed by government securities or with central banks, and transactions where the motivation is to borrow securities rather than to provide cash. The proposals appear to target financing and collateral transformation activities between banks and shadow bank entities, such as hedge funds. If it were to be implemented, it could create a powerful incentive for banks to clear repo transactions via central counterparties. This would provide authorities with greater transparency on what is presently an over-the-counter bilateral activity. Otherwise, if such transactions are not moved to clearing, banks would be required to seek higher collateral amounts when engaging with non-bank counterparties.

⁸ The new formula better reflects the netting between long and short positions in a bilateral netting set, by specifying that haircuts will be negative for short positions and positive for long positions. Diversification benefits apply by dividing the gross exposure of the netting set by the square root of the number of security issues in the netting set.

⁹ Consultative document - Haircut floors for non-centrally cleared securities financing transactions (published in November 2015, <http://www.bis.org/bcbis/publ/d340.pdf>). This proposal does not form part of the second consultation on the revised standardised approach to credit risk.

Figure 19
Basel Equities Collateral Haircuts



Source: Basel

Annex 1: Exposures to Banks

Two methodologies are proposed for risk weighting exposures to banks: the existing ECRA approach, albeit modified for exposures to unrated banks, and the Standardised Credit Risk Assessment (SCRA) approach. The SCRA does not use external credit ratings as a methodology, and is less granular than the ECRA (uses three buckets versus five buckets for the ECRA).

Figure 20

Proposed ECRA Risk Weights (%)

	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Long-term (w/o government support)	20	50	50	100	150	SCRA
Short-term	20	20	20	50	150	SCRA

Source: Basel

Figure 21

Proposed SCRA Risk Weights (%)

	Grade A	Grade B	Grade C
Long-term	50	100	150
Short-term	20	50	150

Source: Basel

Under the SCRA (that is proposed to be used for exposures for unrated institutions across all jurisdictions), banks would classify exposures into three different buckets (A, B and C). A bank may classify an exposure to a higher risk grade even if it meets the minimum criteria. A defaulted bank counterparty receives a 150% risk weight.

Grade A Criteria: Exposures to bank counterparties that have adequate capacity to meet their financial commitments (including repayments of principal and interest) in a timely manner, for the projected life of the assets or exposures, and irrespective of economic cycles or business conditions. A counterparty bank classified into Grade A must exceed the published minimum regulatory requirements and combined buffers (G-SIB, capital conservation and countercyclical capital buffers) established by its national supervisor.

Grade B Criteria: Exposures to bank counterparties that are subject to substantial credit risk, with repayment capacities dependent on stable or favourable economic or business conditions; or where a counterparty does not meet one or more of the applicable published buffers required by its national supervisor.

Grade C Criteria: Higher credit risk exposures to counterparties that have material default risks and limited margins of safety. For these counterparties, adverse business, financial, or economic conditions are very likely to lead, or have led, to an inability to meet its financial commitments. At a minimum, a bank would apply a Grade C risk weight where the bank counterparty has breached any of the published and binding minimum regulatory authorisation requirements determined by national supervisors. Alternatively, if the bank counterparty is required to publish audited financial statements, if the external auditor has issued an adverse audit opinion or expressed substantial doubts for the counterparty to continue as a going concern in its financial statements or audited reports.

Annex 2: Exposures to Real Estate

The use of a debt service coverage ratio as a secondary risk driver for residential real-estate exposures proposed under the first consultation has been removed. Instead, banks are required to incorporate an assessment of a borrower's ability to pay as an underwriting criterion.

The latest proposals increase the risk weightings for residential and commercial loans where loan repayment is materially dependent on cash flows generated by the property (ranging from 70% to 120% for residential exposures, and from 80% to 130% for commercial exposures).

In line with the prior consultation, the value of the property used for LTV is calculated at origination, with the numerator comprising the outstanding loan balance, in line with the initial consultative proposals. Extraordinary, idiosyncratic events that result in a permanent reduction of the property value should direct the bank to reduce valuations. Notwithstanding the requirement to maintain the LTV as at loan origin, the Basel Committee will allow for modifications to the property that unequivocally increase its value to be considered in the LTV denominator.

Figure 22

Proposed Residential Real Estate Risk Weights

LTV ratio

(%)	<40%	40-60%	60-80%	80-90%	90-100%	>100%
Repayment not dependent on cash flows	25	30	35	45	55	RW counterparty
Repayment dependent on cash flows	70	70	90	120	120	120

Source: Fitch

Figure 23

Fitch Estimates - Real Estate Foreclosure Timelines (Months)

Country	Residential real estate	Commercial real estate
Denmark	12	
Japan	12	12
US	15	17
Netherlands	15	36
Australia	15	
New Zealand	15	
Norway	16	
Canada	18	
UK	18	24
Switzerland	21	
Germany	24	36
Brazil	24	
Chile	24	
Colombia	27	
Mexico	27	
Belgium	30	
Ireland	30	30
France	32	36
Portugal	48	
Spain	48	48
Italy	61	60
Greece	96	

Source: Fitch estimates (Structured Finance). The assumptions are derived from the loan-level repossession data and information supplied by servicers during the rating process. The foreclosure timeline assumptions may not reflect actual or ongoing foreclosure timelines, which will vary based on the actual circumstances. For EMEA CRE, a 36-month floor applies where data availability is scarce, based on analyst assumptions. For US timings can significantly vary due to state foreclosure laws

Annex 3: Other Asset Items

Equity and Subordinated Debt

Presently, the SA risk weight assigned to all investments in equity or regulatory capital instruments issued by banks is 100%, unless the investment is deducted from the issuer's capital base (noting that significant investments in the equity of unconsolidated financial institutions not deducted from capital are risk weighted at 250%). The SA risk weightings are notably lower than the non-modelled IRB equity risk weightings (300% for publicly traded equities, unlisted equities attract a 400% risk weight).

Under the second consultative document a 250% risk weighting is proposed for equity holdings that are not deducted from capital – matching the 250% risk weight that banks hold for significant unconsolidated bank equity not deducted from CET1 – and 150% for subordinated debt and capital instruments other than equity, that are otherwise not deducted from CET1.

Figure 24

Equity Risk Weightings

Current standardised, proposed, vs. Current simplified models-based approach



Source: Basel, Fitch

Fitch notes significant variances between jurisdictions' current implementation of equity risk weighting. The US applies risk weightings ranging from 100% to 600%, whereas the EU applies either 100% or 150%, where the latter is designated for "high risk" (venture capital, private equity-type positions). However, we note that under the finalized revised market risk framework, listed equity positions that are fair valued daily through P&L form part of the presumed trading book boundary, so assessing the absolute impact of the proposed changes for the banking book will require some understanding of the implication of boundary changes.

Treatment of Past Due/Defaulted Exposures

Having previously omitted comments on this topic, the Basel Committee proposes that the definition of "past due loans" be as far as possible aligned with the IRB approaches' "definition of default". This will require banks to take into account other indications of unlikelihood to pay and or distress, alongside the "backstop" 90 days past due threshold. The unsecured portion of such defaulted exposures would be risk-weighted 150% and the secured portion would be risk-weighted in accordance with the credit risk mitigation framework.

The impact at jurisdictions will ultimately vary depending on the final implementation, which can only take place once these guidelines are finalised. However, EU banks are unlikely to be affected as existing EU rules already align the SA definition of default to the IRB definition. As US banks solely use a 90 days past due definition for SA, the inclusion of other indications of unlikelihood to pay could increase defaulted exposures and SA RWAs. Consequently, this could affect the capital floor assessment (capital adequacy based on the lower of the standardised or the advanced approach calculated ratios).

Annex 4: Risk Mitigation Framework

Use of Credit Ratings

The Basel Committee proposes to use credit ratings as one method of determining supervisory haircuts for financial collateral items. For banks that use SCRA, a less granular range of supervisory haircuts are outlined, that relying upon an “investment-grade” determination, based on eligibility criteria for corporate guarantors that at first take appears to borrow heavily from the current US implementation of Basel III. In contrast to the first consultation, the second consultative document permits the use of non-financial (i.e. corporate) guarantees as financial collateral for securitisations.

Minimum Repo Haircut Floors

The fundamental principle of the proposed approach is that, for any repo transaction or netting set of repo transactions, the bank must treat the transaction as an unsecured loan for the sake of calculating capital requirements if the actual collateral haircut is less than the prescribed haircut floor. The proposal is intended to apply to uncleared trades with non-banks where cash is lent for collateral or collateral is lent for collateral.

Figure 25

Proposed Haircut Floor Impact

USD100 cash for USD101 “AA”

Corporate debt, 12-year maturity, to
unrated corporate counterparty

Net exposure at default

SA RWA
(to unrated corporate)

Current SA Collateral calculation	USD3.66	USD3.66
Proposed Minimum Haircut calculation	USD100	USD100

Source: Fitch. Assumptions: Transaction implied haircut is 1% $[(101/100)-1]$; proposed Basel haircut floor is 4%; current rules supervisory collateral haircut 5.657%; under proposed regime the reverse-repo is treated as an unsecured loan

CDS Without Restructuring Clause

The first consultation proposed that banks could no longer recognise credit derivatives that lack restructuring clauses as eligible credit-risk mitigation. However, significant concerns were expressed by US respondents, who argued that CDS referencing US counterparties did not generally feature restructuring clauses. This was due to specific legal characteristics of the US insolvency framework – namely mandatory lender/holder unanimity clauses to restructure most debt, alongside the absence of debt restructurings outside of bankruptcy proceedings.

Consequently, the Basel Committee has chosen to continue recognising CDS without restructuring as eligible credit risk mitigation, pending feedback on the conditions under which restructuring may not be a necessary event for full recognition. Were CDS without restructuring banished as eligible unfunded risk mitigation, this would have seriously undermined the market in the US for existing CDS mitigation contracts and would have risked introducing clauses that would have little legal worth (not to mention potentially additional expense in protection payment amounts).

Annex 5: Abbreviation Glossary

	Definition
BCBS	Basel Committee on Banking Supervision
BTL	Buy-to-Let
CCF	Credit Conversion Factor
CDS	Credit Default Swap
CEE	Central and Eastern Europe
CEM	Current Exposure Method
CET1	Common Equity Tier 1
CRE	Commercial Real Estate
CVA	Credit Valuation Adjustment
DSC	Debt Service Coverage
ECB	European Central Bank
ECRA	External Credit Risk Assessment Approach
Edwin	European Data Warehouse
EMEA	Europe, Middle East and Africa
FC	Foreign Currency
G-SIB	Globally Systemically Important Banks
IDR	Issuer Default Rating
IG	Investment Grade
IMA	Internal Model Approach
IMM	Internal Model Method
IRB	Internal Ratings Based
LATAM	Latin America
LTV	Loan-to-Value
OECD	Organisation for Economic Cooperation and Development
RMBS	Residential Mortgage Backed Securities
RW	Risk Weighting
RWA	Risk Weighted Asset
SA	Standardised Approach
SA-CCR	Standardised Approach to Counterparty Credit Risk
SCRA	Standardised Credit Risk Assessment Approach
SME	Small and Medium-sized Enterprises
SREP	Supervisory Review and Evaluation Process
SRF	Support Rating Floor
UCC	Unconditionally Cancellable Lines of Credit
VaR	Value-at-Risk
VR	Viability Rating

Source: Fitch

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