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FRENCH BANKING FEDERATION RESPONSE TO BCBS CONSULTATION ON REVISIONS TO THE STANDARDISED APPROACH FOR CREDIT RISK

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

I- General comments

The FBF welcomes the opportunity to respond to the Basel Committee's consultation on revisions to the Standardised Approach (SA) for credit risk. We are keen for this consultation to open the floor to a constructive discussion on how to revise the standardised approach for credit risk and would like to engage into an iterative process with the Basel Committee in order to strike the right balance between the need to update the framework, the identification of parameters that are risk-sensitive, simple and comparable and the implementation of forthcoming new requirements in practice.

It is our view that these proposals together with the ongoing consultation on the Capital Floors Framework and the forthcoming review of the Internal Rating Based approach may entail wide-ranging impacts on the banking system and on how banks do business.

The results of the Quantitative Impact Study will be key from this standpoint: we urge the Basel Committee to carefully review the calibration of the risk weights with at least another QIS subsequent to the ongoing one as we believe it would not be realistic to calibrate a complete overhaul of the standardised approach on the basis on one single date point.

On this basis, we would like to ask for extending the timeline for this review beyond the planned end-2015 deadline. Our members look forward to the opportunity to complement the Committee's work and share their analyses.

Key messages

- Impact of the proposed review :

The executive summary of the consultative document states that "increasing overall capital requirements under the standardised approach for credit risk is not an objective of the Committee; rather, capital requirements should be commensurate with underlying risk." The proposed changes, however, indicate that capital requirements would mechanically increase particularly for high quality portfolios –for example, the lowest risk weight for bank exposures would increase from 20% to 30%, while that applicable to corporate exposures would increase from 20% to 60%. The proposed risk weight for mortgage exposures will also have negative impacts on the capital requirements, as it will de facto become the corresponding capital floor for this portfolio. Moreover, as an unintended consequence, the new SA on credit risk will have implications on the TLAC calculations.

- Portfolio granularity should be introduced into the framework:

The issues identified in the consultation document clearly show that a one-size-fits-all approach has its limits and may only lead to unintended consequences. The corporate portfolio is one obvious example that a homogenous approach does not work in practice, given the wide variety of counterparties that are included in this portfolio. Another example is provided by residential real estate markets which reflect long standing domestic specificities (please refer to Annex 3 for a demonstration of the equivalence of the French guaranteed loans to mortgage loans). On the one hand, risk drivers uniformly calibrated across jurisdictions, may lead to operational complexity and, by fostering homogenous prudential treatment, ultimately miss out on the risk sensitivity goal and lead to an increase in systemic risk on a given portfolio. On the other hand, the guarantee framework to secure loans differs significantly from one jurisdiction to the other, due to specificities in the legal environment, the application of insolvency proceedings, etc... As a consequence, we believe more granularity and a stronger risk based approach should be introduced into the framework.

- Reliance on external ratings:

We understand the G20's general mandate to reduce over-reliance on external ratings. We note that the Committee in its principle 5 appears to recognize that it may not be feasible to entirely remove external ratings from the framework. For the time being, the "Committee has chosen not to rely on ratings as a risk driver…" Its primary concern is to ensure that ratings do not become "…a substitute for credit analysis". External ratings could be considered as a component of the SA, for example in the case of large corporate exposures, including SMEs, and bank exposures. We believe external ratings should complement risk drivers, as they are more risk sensitive: the proposed risk drivers are point in time and for each exposure class they only focus on two characteristics (e.g. for banks they focus on the CET1 ratio and the Non-Performing Asset ratio, but do not take into consideration country of incorporation, liquidity adequacy…). As the new capital floor framework will rely on the proposed SA, it is paramount that standard RWA do not deviate significantly from the IRBA RWA. In that perspective, we suggest to use external ratings where available as a complement to counterparties risk assessment.

- The corporate portfolio:

Corporate exposures cover a wide and diverse range of clients: insurance companies, funds, specialised lending institutions, all of which will be evaluated through two risk drivers (revenue and leverage) which do not correctly represent the associated risks with each of these sub-segments.

We do not understand why the Committee writes that "empirical evidence shows that specialized lending generally exhibits higher risk and losses than other types of corporate lending" –we believe this statement is not accurate in relation to Project finance, Object finance, IPRE (Income Producing Real Estate Producing) and Commodities finance. Proposed RWA should better reflect the hierarchy of risks within the various categories of specialized lending. A detailed description of an example of specialised lending is set out in Annex 2. We would welcome feedback from the Committee on our analyses and would like to engage in an open discussion on the right segmentation and risk drivers to be considered for the corporate portfolio and its sub categories in order to reach adequate RWA calibration on specific businesses such as specialised lending. Finally, we would also like to draw the Committee's attention to Annex 1, focusing on real estate development in France, for an additional example of the functioning of a specific corporate portfolio.

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Please find our responses to the consultation questions below. We tried to analyse the proposals in light of the 4 objectives regularly mentioned by the Committee, i.e. comparability, transparency, simplicity, risk sensitivity. In many instances we have come to the conclusion that the proposed changes would likely result in more complexity, as required information may not be readily available, and due to accounting specificities for example, the required data will not be comparable.

As stated above, we are supportive of a constructive iterative discussion with the Committee complemented by an additional QIS in other to substantiate more fully the new standardised approach calibration.

Please also find in the annex special focuses on: real estate development in France (Annex 1); trade & commodities finance –a joint paper by French and Dutch banks (Annex 2); and residential real estate in France (Annex 3).

II- Answer to questions related to the consultation

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

The capital adequacy ratio is obviously an essential indicator to appreciate credit risk on bank exposures portfolio. Nevertheless, individual banking counterparty analysis should be based on other indicators, including liquidity, geographical location, governance, risk management…

The leverage ratio seems to be less adequate than the CET 1 ratio or the Tier 1 ratio as leverage is meant to be a backstop measure but not a driver for risk. The use of the leverage ratio to risk weight bank exposures also brings up potential problems due to national specificities in accounting standards.

Going one step forward, it could be useful that the Basel Committee further details the case of a bank subsidiary which belongs to a non-bank group or which has no strong links to its holding company, in particular when this subsidiary does not publish any indicator or risk drivers.

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

The net NPA ratio proposed in the consultation is more adequate than the NPL ratio which does not cover the whole balance-sheet. Nevertheless we observe different practices in banks' disclosures, as a result not all required information may be readily available in order to calculate the NPA ratio.

The net NPA ratio can be an effective measure of the quality of banks' balance sheet, but it also can be misleading in specific situations. For instance, some guarantee funds are not homogeneously and/or fully recognized under the regulatory capital calculation rules across jurisdictions, while they are economically effective in covering credit risk. This may further undermine NPA ratios comparability. Thus, the use of external ratings should be allowed by the regulator in specific situations, in order to reflect banks' balance sheet quality and risk management approaches more accurately.

We may object to the use of the NPA ratio due to the lack of comparability across jurisdictions, and this at least for a transitional period of time, while the regulatory definition of default is normalised.

The usage of the NPA ratio will also durably suffer from insufficient disclosure from banks that do not apply Basel III standards. We may encounter this issue not only across regions but also within a region that does not apply the Basel III framework to local players.

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

We are in favour of a discount weighting for short-term interbank exposures which truly support interbank liquidity. The proposed floor risk weight of 30% implies a 50% increase in the capital charge for short-term inter-banks claims which does not appear to be justified.

Given the nature of the interbank market where some actors may keep a long or short position for longer than a 3-month period, we think that the wording of the condition "which are expected to be rolled over" is not adequate and disqualifies from the preferential treatment interbank placements that are normally rolled over. This would have implications not only on capital requirements, but also on liquidity provisions amongst banks. As such, we propose to delete this phrase from the definition of short-term interbank claims.

The reference to the original maturity of the transaction also seems counterproductive, since it introduces a disconnection between daily risk monitoring (based on residual maturity) and regulatory requirements. The original maturity may be meaningful from a liquidity management standpoint (such as in the LCR framework), however, we do not see its relevance from a credit risk management standpoint.

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

As recognised in the consultation document, the CET1 ratio can be different due to national discretions, buffers and Pillar 2 requirements mandated by National Competent Authorities, all of which make the ratio not comparable across jurisdictions. The NPA ratio computation is also dependent on local rules, especially accounting standards, and will need to be clarified in terms of definition and calculation in order to ensure comparability.

The use of CET1 and net NPA ratios would make the standardised capital requirements for banks more procyclical. This would lead to higher capital requirements for banks in a downturn environment, thus compounding the risks that banks would be facing in such an environment.

Applying a 300% risk weights to an institution in breach of its minimum prudential standard does not seem relevant as some financial institutions do not disclose the minimum binding capital requirements imposed on a case by case basis by their national competent authorities. Corporate risk drivers for banks incorporated in countries that do not apply the Basel III standards are equally not adequate. As an alternative to the use of the corporate risk drivers for these banks, we suggest using the eternal rating of the bank's country of establishment, and to apply to it a de-notching, or to use the bank's external rating when available.

As mentioned in question 1, the leverage ratio is not an appropriate risk indicator since by construction it is not a risk sensitive ratio.

Proposed risk drivers should take into account the country where the bank is located, as well as its regulatory environment and applicable legal framework (e.g. enforceability of guarantees). We can simply illustrate that additional drivers are necessary to assess the risks of banks through an example. In the table below, we compare the RWA calculated according to the Committee's proposals for 3 banks based on their published CET1 Basel III and NPL (as a proxy of the NPA):

Bank Name	Country	Date	Rating	CET1 Basel 3	NPL	RWA new SA
Ziraat Bank	Turkey	12/31/2014	Baa3	17.2%	4.2%	60%
Bank Audi SAL	Lebanon	12/31/2013 [*]	B2	7.8%	2.8%	[80% - 100%]
BNPP	France	12/31/2014	A1	10.3%	4.2%	80%

- [*] 12/31/2014 not available
- Source data: annual reports ; Ratings: Moody's Dec 2014 (Long-Term Bank Deposit Foreign Currency)

As illustrated above, on the basis of proposed risk drivers only BNP Paribas will be assigned the same RWA level than Bank Audi SAL, without taking into account for example country risk or other factors that may have been reflected by these banks external ratings.

Therefore our recommendation is to use external rating as a complement to the Committee's risk drivers as they provide information on the country of incorporation of a bank (information on the political context, legal environment…).

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

Context

We believe that it is not appropriate to limit the risk analysis to only two drivers:

- The corporate portfolio is very heterogeneous and not based on a single definition
- Proposed risks drivers do not allow to discriminate risks across this variety of counterparties
- For some sub categories of Corporates, it is impossible to apply the proposed risks drivers.

As already outlined in the introduction, there are other important factors to be taken into account for risk assessment, for example:

- the economic sector a corporate belongs to and the specific positioning of the corporate within a given sector,
- the country of risk,
- the quality of management,
- the access to financial markets,
- the maturity profile of debt ….

In addition, at transaction level, we should not forget about collateral, pledged assets and guarantees, which are important risk management tools for a bank. We believe therefore that it is not appropriate to limit the risk analysis to only two drivers.

- The proposed risk drivers could differ due to the accounting GAAPS. Indeed, the national accounting framework can have high impacts on the leverage ratio, and introduce a distortion of competition between geographies. While in Europe listed corporate entities are obliged to disclose their financial statements at consolidated level under IFRS GAAP, other entities still establish their statutory accounts in a local framework (e.g. French GAAP in France).
  Yet, whereas the local European GAAPs generally prohibit the netting of derivatives, in IFRS the issue is tricky (admitted in only rare cases with duly documented Master Netting Agreements) and in the US, the netting of derivatives is generally adopted.
  Hence, for a given product accounting measurement will be different due to the applicable framework (US GAAP, IFRS, French GAAP), which is in contradiction with the comparability purpose of the proposed standard approach.

- The leverage ratio benchmark is not comparable among industries. The proposed framework is not adapted to insurance companies whose leverage (before including off balance sheet exposure) will always be above 5 and thus will not differentiate their risks. We suggest thus the

Committee to use risk indicators relevant to the insurance industry –please refer to the dedicated paragraph below.

- The leverage ratio (asset/equity) is ultimately not relevant for analysing risks on corporates as such :
    - It does not take into account the intrinsic profitability of the counterpart
    - It disregards the intangible aspects (e.g. goodwill) which may considerably improve the asset part while being totally insubstantial in reality, thus altering the ratio and its meaning.

- Annual revenues and annual account are not available for all corporates, in particular on some SMEs under local legislation with no legal obligation to disclose annual accounts, and for which other risk indicators are used by banks to assess the risk at inception of the business relationship (private rating agencies, history of accounts, secured financing, etc…). Please refer to question 6 for further details on this point. When the accounts of a subsidiary are not available, we would like to propose using the consolidated accounts of the parent company.

Exposures considered as "corporate" on which the application of the proposed risk drivers is not consistent

The **corporate category is de facto the residual category in which all exposures not belonging to other categories are included**. As such, even if available, the proposed risk drivers may not be meaningful for certain entities (e.g. non-bank financial institutions, insurance, funds, religious entities, etc.).

- **Insurance companies**

In particular, **the proposed framework is not adapted to insurance companies** whose leverage ratio (before including off-balance sheet exposures) will always be above 5, and thus will not differentiate their risks. As an illustration, Aviva, AXA and AIG show a leverage ratio of 25, 13, and 5, while corresponding ratings are A+/A1, A+/Aa3, and A-/Baa3, respectively.

We consider that a specific treatment is necessary regarding exposures to insurance companies, especially owing to their role in financial risk mitigation, and to their contribution to the most efficient risk allocation across various players and sectors. European regulators have put tremendous efforts in the new Solvency 2 framework, to ensure that capital requirements be closely aligned with risks taken. We think that levels of SCR (Solvency Capital Ratio) would be far more meaningful as risk drivers for these counterparties even though they may exhibit a volatile pattern. For non-European entities, several jurisdictions have been deemed equivalent to Solvency 2 by regulators, and the risk metrics used in these countries would also be more relevant than blind measures based on leverage and turnover. Country specific calibrations (and even at business line level: Life / Non-Life) would enable to capture these fundamental specificities more accurately. For instance, loss ratios and combined ratios could usefully complement risk assessment as far a Non-Life companies exposures are concerned.
We suggest thus the Basel Committee to use risk indicators relevant to the insurance industry.

- **Wealth management**

  We would also like to highlight that wealth management (or Private banking) is not qualified as "retail credit portfolio" due to the concentration of risk on some key clients, even though wealth management clients are by nature private individuals (directly or indirectly). A bank with a wealth management arm will thus have to treat its clients according to corporate exposures rules as they do not qualify for the Retail Portfolio. Private banking is mainly conducted on (i) private individuals and (ii) their wealth-management structures (e.g. trusts), which are analysed and reported according to a corporate approach from a credit approval and monitoring standpoint (no scoring/no homogeneous risk class). However wealth management clients do not generally publish consolidated audited accounts –this makes leverage rate calculations impossible. We therefore propose to segregate wealth management "corporates" from commercial companies, and to apply the obligation for audited consolidated leverage ratios to commercial companies only. Instead of considering the total leverage ratio of the client, we propose to calculate a leverage ratio as: Assets under Management (AUM) recorded in wealth management books / Net Asset Management (=AUM – Loan amount) in reporting banks' books.

- **Real Estate Investment Trusts (REITS)**

  A REIT company should not be considered as a « standard » corporate as it shows generally a low LTV and owns a diversified real estate portfolio, leading to rental revenue resiliency and shock absorbing capacity which translates into low PDs and LGDs. As such and given the importance of REITs in developed market economies and similar characteristics of REITs from one country to another, a specific set of risk drivers should be considered. We would like to suggest:
    - Total Asset (versus Revenue for instance)
    - LTV
    - Interest Coverage Ratio

- **Companies belonging to groups**

  Particularly in the business of large corporate customers, we are generally not facing relationships between the bank and one, isolated, counterparty, but with large, often internationally diversified groups consisting of very different types of counterparties, more or less interdependent. For example:
    - **Holding companies** with generally no or little revenue ;
    - **Subsidiaries with various activities** such as industrial, financial, distribution subsidiaries. As risk drivers are applied at a company's level and not at a consolidated level, this approach could give a wrong image of some subsidiaries (e.g. emerging subsidiary in a new market supported by its parent company, small but very performing company etc.)

  We believe it is therefore key to assess credit risk on the basis of consolidated accounts and not social accounts, as credit risks on two different corporates may be fully correlated, either through legal links (e.g. a majority ownership) or contractually (documentation establishing an equal treatment between two senior credit exposures) or through cross-guarantees.

- **SPVs**

  It is important to take into account the fact that many SPVs do not generate any revenue or operating profits and that most of their net result is driven by their financial profit. A 300% risk weight would ultimately render this type of business activity unviable.
  Many SPVs used for specialized financing, for example object financing and real estate financing (please see Annex 1), are not obliged to publish financial statements, and thresholds for publication are relatively high. Due to the principle of highest of corporate or specialized lending weighting introduced in paragraph 28 of the consultative document, these exposures would be weighted 300% which does not reflect the associated risk –please also see question 8.

- **Funds**

  Loans to investment funds should not be treated as corporate exposures because the information required is not relevant in this instance. A 300% risk weight with no regard to the true risk profile of these exposures would therefore apply indiscriminatingly to a very diverse and complex class of exposures for which risk can be considerably lower than the risk represented by corporate exposures. We propose an alternative approach based on investment funds regulatory framework, based on objective and transparent criteria across worldwide jurisdictions, where:

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

Alternative approach for "core" corporate exposures

We believe that the corporate portfolio represents a too wide variety of exposures, and would strongly recommend the Committee to consider a more granular segmentation within this portfolio.

On the basis of the arguments laid out above, we would like to propose an alternative approach in order to deal with "core" corporate exposures, i.e. a corporate portfolio that may not include exposures to insurance companies, to specialised lending (please refer to question 8 for our detailed arguments), to funds, etc…

The following risk drivers are commonly analysed by rating agencies or banks when assessing the corporate credit risk; they could be used under the Basel Committee proposal:

- Corporate size : revenue ;
- Structure : net debt / EBITDA ;
- Profitability: EBITDA / revenue.

These risk drivers could complement those proposed by the consultative paper. As mentioned in the introduction, we are keen to engage with the Committee on this matter.

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

The fact that large corporates and SMEs are subjects to the same risk weights table, partially based on revenue, is very detrimental to SMEs. Indeed, SMEs having by definition a revenue lower than EUR 50m, this risk driver will segment the SME sub-portfolio into two buckets only (revenue ≤ 5m and revenue between 5 and EUR 50m), leading to a minimum 90% risk weight in the best case.

As stated in page 10 of the consultative document, "ratings may be good predictors of corporate defaults". As an illustration, most French SMEs are rated by "FIBEN", an External Credit Assessment Institution provided by the Banque de France and a reliable source of risk sensitive information. We therefore support complementing Basel risk drivers with ECAI ratings where available.

A consequence of changing from risk weights based on external ratings to the ones proposed in the consultative document would be that exposures to top credit quality SMEs, currently weighted at 20% (based on the above mentioned FIBEN ratings), would in the best case be weighted at 90% under the revised standard approach.

This may be particularly detrimental to banks that specialise in SMEs financing and to the viability of their business model.

We propose therefore to distinguish, within the corporate portfolio, the SME exposures from the Large Corporate exposures. We believe that this distinction complies with the revised Standardised approach objectives:

(i) "reconsider the design of the standardized approach to ensure its continued suitability for calculating the capital requirements for credit risk exposures"

As with the IRB regulatory categories, a distinction between SME and Large Corporates depending on the client's revenue is suitable, the client's revenue being a useful tool for banks to discriminated between these two sub-portfolios (SMEs and Large Corporates). It would also meet the objective of aligning the categories between IRB and standardised approaches.

(ii) "ensure that the standardized approach is appropriately calibrated to reflect to a reasonable extent the riskiness of exposures"

This would be consistent with the IRB approach, where SMEs and Large Corporates are not combined for rating modelling purposes. As explained in the *Explanatory Note on the Basel II IRB Risk Weight Functions* published in July 2005 by the BCBS, "smaller firms are more likely to default for idiosyncratic reasons" than large corporates which present a "higher dependency upon the overall state of the economy".

(iii) "increase comparability of capital requirements under the standardized approach and the internal ratings-based (IRB) approach by aligning definitions and taxonomy, where possible"

In order to be consistent with IRB categories[1], we propose to set the threshold of €50m as a frontier between these two sub-portfolios (SMEs and Large Corporates).

As far as risk drivers for SME exposures are concerned:

- We support the leverage ratio which is an efficient risk driver on this population. Two modules (with a threshold at 5 for instance) would enable to bring both discrimination and simplicity to the standardised approach.

- We believe that the revenue is not an appropriate risk driver for the SME population :
    - A bank has tested this variable on this population in its IRB rating modelling: the revenue ranked 114th out of 138th tested variables (in terms of Cramer's V)

    - On this population, a bank has computed default rate by revenue bucket. As shown in the table below, there is no obvious relationship between the default rate and the revenue:

SME's 12-month default rate by revenue bucket

Revenue bucket	12-month default rate	12-month default rate
< €1m	2,8%	3.0%
€1m≤ x < €5m	3,2%	
€5m≤ x < €10m	3,1%	2.6%
€10m≤ x < €30m	2,4%	
≥ €30m	2,5%	

Beyond the risk drivers described in the consultation, the Committee may try to refine the risk sensitivity of its approach on the SME perimeter by contemplating the following variables:

- For smallest counterparties, usually subject to a higher sensitivity to short-term events and a simpler balance sheet structure:
    - Supplier payment term (in purchasing days)
    - Interest expenses / turnover
    - Cash flow / turnover
- For larger SMEs, the profitability and the balance sheet structure are significant:
    - Share of the Short-Term Debt
    - Interest Cover (Gross Operating Profit / Gross Interests)
    - Profitability (such as EBITDA Margin)
    - Net debt/EBITDA

[1] In the IRB asset correlation function, size adjustment becomes zero for borrowers with €50 million annual revenue and above.

We acknowledge that such financial variables are not always available (and even less frequently publicly available) and urge the Committee to consider that the absence of such variables does not necessarily mean a higher risk level (especially on the smallest clients), thereby implying that reasonable average risk weights should remain as an option in such cases.

A distinction of SMEs within the Other Retail category could also be considered by applying the same (for simplicity purpose) Corporate SMEs risk drivers, with specific thresholds and specific calibration, retail SMEs being riskier than Corporate's ones.

(iv) "increase comparability of capital requirements between banks using the standardized approach by reducing national discretions, where feasible"

Our proposal to distinguish large corporates and SMEs is in line with the objective and is neither better nor worse than the Basel Committee's proposal:

"reduce reliance on external credit assessments by providing alternative measures for risk assessment, where possible."

As stated above, we support complementing the Committee's proposals with ECAI ratings where they are available.

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

- **Performance and risk sensitivity**

Risk sensitivity is important in the context of the standardised approach as RWA calculations based on the latter will be used as a floor to the IRB approach. A risk sensitive standardised approach would reduce the gap between standard and IRB calculations.

As for internal models, standard criteria used here must be intuitive, unambiguous, discriminating, uncorrelated between them and positively linked to risk. We think that the proposed criteria do not meet those objectives. As stated in other sections of this document, we think other drivers may bring additional predictive power on specific portfolios such as exposures to insurance companies, or real estate portfolios.

As already mentioned above, the following risk drivers are commonly analysed by rating agencies or banks when assessing the corporate credit risk, they could complement the Committee's proposal:

- Corporate size: revenue
- Structure: net debt / EBITDA
- Profitability: EBITDA / Revenue

- **Calibration**

This will be the central element of the QIS. However we think it is important to stress once again that the risk weights proposed for corporates in the consultation paper are too high.

The Committee has intended to propose a more risk sensitive SA. That can be measured through a very simple and usual performance test, like an Accuracy Ratio for example. This is made possible by the fact that the Committee has given some indications on how the proposed risk weights have been reached (fixed 45% LGD and fixed 2.5y maturity for wholesale exposures for example), thus allowing to find a shadow PD behind each RW.

To illustrate this issue, we derived implied default probabilities from the Risk Weights proposed for corporates in the consultation paper, inverting the Basel 2 formula for corporate exposures, (using a fixed maturity of 2.5 years, a fixed LGD of 45% (as per IRB Foundation parameters) as explained above), and conservative assumptions on client turnover. The derogatory treatment on SME exposures (as per Article 501 of EU Regulation N° 575/2013 (CRR) wasn't taken into account, in order to fully reflect the spirit of the Basel texts. The range of resulting implied PDs was then compared to the average default probabilities observed by the major rating agencies on the same borrower perimeter over a long economic cycle.

The following conclusions were drawn from the exercise:

- The implied default probabilities broadly correspond to what agencies observe in terms of default rates for ratings covering the range of BBB down to CCC- (on S&P scale) without attributing a rating to all the sub grades between these grades. It therefore looks impossible to reach the highest rating levels, although such ratings can still be attributed and justified for the largest corporates (indeed for this segment the defaults are scarce enough to justify a lower PD than the one implied by the new standard approach). We could then imagine that such counterparties may face increased RW under the new Basel approach, and hence an increased cost of funding owing to higher costs of capital for lending banks.
- The implied Accuracy Ratio (AR, a traditional measure of the performance and reliability of a rating system) built on these implied PDs is in the range of 25-30%, which is not bad for such a standard approach. We think this corresponds to a classification system which returns an average performance, positioned right in the middle between a random risk classification (where AR equals 0%), and the performance of a good internal model (with AR in the range of 60% and above).
- Finally the bank then slotted its actual corporate loan portfolio from developed countries into the RW buckets of the consultative paper, and compared the observed default rates on the portfolio one year later. The observed default rates were relatively uniform for each Basel RW bucket. Although the discriminatory power of the system can be deemed correct, it then remains below that of a comprehensive expert rating system. As expected, the restriction to two risk drivers in the Basel approach limits the magnitude and accuracy of the risk assessment.

In conclusion, proposed risk weights can be considered too high compared to observed historical risk levels, and do not cover the whole risk spectrum (whereas this should be expected from a risk-sensitive framework). The current proposal is likely to harm the better part of the risk spectrum, which will probably look for financing sources outside of the regulated banking industry.

- **To what extent does the proposal result in (Pro)cyclicality of capital requirements?**

This aspect is not mentioned in the Committee's paper but is of paramount importance. We acknowledge that risk sensitivity inevitably entails a part of procyclicality, but this should remain as limited as possible and a "through the cycle" capital requirement should be set as a target. As a floor to IRB RWAs, a procyclical standardized approach could have undesirable effects, being more constraining in bad times than in good times.

We suggest that the Basel Committee perform some studies to check whether the proposed standardised risk weights remain stable for a large sample of counterparties on several years spanning over a period with upturns and downturns (likely to entail changes in the risk drivers suggested in the proposal, with a subsequent impact on RWAs) in order to ensure sufficient stability of capital requirements over the long run.

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

We strongly support the introduction of specialised lending sub-portfolios, provided that the proposed risk weighting methodologies are indeed risk-sensitive.

There are many asset classes within the specialised lending category: project finance, shipping, aerospace, trade and commodity finance –please refer to our special focus on trade and commodity finance available in Annex 2, jointly drafted by French and Dutch banks.

However, **we do not concur with the Committee's statement that "*specialised lending generally exhibits higher risk and losses than other types of corporate lending*".**

In this regard, we would like to request that the **Committee makes available the analyses and data which served as the basis for this assertion.**

We also wish to underline that **the application of a standard approach based on a simplistic risk assessment is particularly inappropriate for specialised lending transactions.** The transactions are indeed sophisticated and structured to ensure the best level of protection based on a number of key risk controlling features. Besides, the bulk of these transactions are carried out by large banks under an IRB approach that could be subject to the floor to the standard approach while banks under a straight standard approach have a limited activity in specialised lending.

We believe it is key that the new standardised approach introduces sufficient discrimination to avoid punishing treatments for safe and properly collateralized / secured SL structures.

1. *A minimum 120 % would be unduly punitive and will remove any risk sensitivity*

Security packages over collateral and control of cash flows, typical for specialized lending, have demonstrated their effectiveness and collateral/cash flows have a constantly monitored value.

As a global benchmark to assess the performance of specialised lending, the European Banking Authority's Transparency exercise started in 2013 shows that the total outstanding **value**

adjustments and provisions for all European banks in the panel, at around 3.4% of exposure at default, was similar for specialised lending and for corporate lending as a whole. Specialised lending showed a higher overall default rate compensated by a better recovery rate.

In Project Finance, market studies have been collecting default and loss data for 20 to 30 years from a large group of banks. The data set includes thousands of projects and hundreds of defaults. With average yearly default rates of around 0.8% and loss rates slightly in excess of 20%, **project finance exhibits a robust performance**.

The application of a **120% risk-weight floor is by far too excessive for specialised lending activities**. The introduction of the specialised lending category in the current text seems to consist in practice in applying broad floors to the Senior Corporate Exposure risk-weighting table. These floors reduce the risk sensitivity of the approach for these exposures, which goes against the aim of the Committee.

We would also like to emphasize that the lack of "Audited Financial accounts" for many SL Object Finance Special Purpose Companies (SPCs) is not meaningful from a risk analysis point of view, since such accounts do not bring any additional information compared with those related to the lessee/borrower and the financed asset itself, the value and cash-flows of which are already closely monitored through regular asset review (lease structures would also show a net result close to zero, asset depreciation and loan amortization at the same level, and negligible often uncalled capital).

In a highly competitive global market, it is common practice for owners / lessors to incorporate SPCs (i.e. borrowers / lessees) in countries where there is no legal obligation to issue accounts. According to the consultation, this prevailing market practice **would automatically trigger a 300 % punitive threshold, completely out of proportion with the actual risk related** to closely monitored 1st priority secured loans.

Application of the proposed floors (120% / 300%):

- Would seriously impact the real economy by reducing the profitability and the availability of credit, or leading to **unsustainable increases in the cost of credit for large sectors** (e.g. Transportation industry, Energy, Infrastructure...).
- Would also significantly **increase distortion between regulated banking sector and non-regulated shadow banking/investors**,
- Would **contribute to the expansion of non-regulated financing and shadow banking** and the reliance on volatile capital markets (if and when available).

To conclude, a minimum 120 % threshold will eventually increase the credit risk and could encourage higher yielding transactions which by nature are more risky. Moreover, the application of thresholds is not consistent with SL financing **and will jeopardize Real Economy financing** such as: PPP, industrial projects (infrastructure, power), transportation, real estate, commodities…

2. *Corporate risk drivers are not relevant for SL*

The proposed risk drivers (revenue and leverage), already considered not adequate for Corporates (see question 5), appear even less applicable to SL portfolio, for which corporate-like financial ratios are not relevant:

- The proposed methodology fails to take into account the specificities and strengths of specialised lending transactions, such as **valuable assets, control of cash flows and ring-fenced structures**.
- In Object Finance (Aviation, Shipping) and in IPRE financing, borrowers are mostly ring-fenced, bankruptcy-remote, SPCs. Transactions consist in closely monitored 1st priority secured loans. While only a portion of the asset is financed, senior loans benefit from a 1st priority ranking in the disposition proceeds of the asset, which is subject to regular independent valuation and providing a safety cushion.
- **In Commodities finance**, the bulk of exposures are very short-term, **secured, self-liquidating transactional arrangements.** Over many years and many thousands of transactions, low defaults and high recovery rates are unrelated to revenues and leverage (please see Annex 2 for our focus on Commodities Finance).
- **Regarding Project Finance,** assets financed are infrastructure assets providing essential products or services, and operated in organized/regulated markets, generating sustainable cash flows over the long term. They comprise large long-term infrastructure assets such as social and transportation, natural resources, telecommunication and power infrastructures. The control of Cash Flows is obtained with various collateral packages and covenants. Low defaults and high recovery rates are observed on this asset class and Risk Weight can be assessed only from a combination of numerous parameters. Given the characteristics of Project Finance, revenues and leverage are clearly either inappropriate in most cases or too limited.

More generally, the risk of SL transactions lies in various criteria and **we propose to Basel Committee to consider, depending on each subset of SL, a combination of alternative risk drivers more appropriate for the analysis of risks,** which are market / asset / structure / cash flow driven… among which but not limited to:

- Loan to Value
- Asset liquidity
- Recourse (Yes/No)
- Repayment Profile versus Object Economic Lifespan or Project Life
- Relationship between cash flow generation and financing conditions: Net Debt/EBITDA, ICR…
- Market cycle
- Asset quality
- Cash flow providers (off-takers, lessees, time-charterer)
- Cash flow predictability

We welcome the opportunity to share our ongoing work on all asset classes included in the specialised lending category with the Committee.

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

We believe there is a strong inconsistency of calibration in the proposed framework: if unsecured regulatory retail exposures are risk weighted at 75%, it would be inconsistent for exposures secured by property to reach levels above that, such as the 80% or 100% being proposed, on the basis of LTV and DSC.

We would also recommend that the 0.2% diversification criterion should be measured at the group level rather than at the level of the entity.

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

We would like to draw the Committee attention to Annex 3, which provides a focus on Residential Real Estate in France.

The LTV ratio has predictive power on loan default and/or loss incurred for exposures secured by real estate.

We welcome the introduction of the DSC ratio, a risk driver that takes into account client solvency. We acknowledge that the DSC implementation could be operationally difficult at first, as there is no homogeneous definition across countries.

In order to take into account the wealth of the clients, we suggest replacing a strict calculation of the DSC ratio by a gradual scale appreciated by a bank's credit committee of the adequacy of the transaction to the level of global wealth of this client.

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

We see two issues with the proposed DSC calculation:

(i) the proposed calculation is "net of tax". Depending on the jurisdiction, and whether it uses or not payment of income tax at source, the ratio may or may not be computable. Also, depending on jurisdiction, the array of taxes may go well beyond income tax, which would unduly complicate the calculations (e.g. property tax), and may not be a market practice in some countries.

(ii) for buy-to-let loans, one might certainly want to guard against excessive expected rent from the property being financed, but removing any recognition of that rental income as a matter of course is hard to justify and would severely affect the ability of retail investors to take part in the private rental market, with obvious macro-economic consequences.

Regarding the LTV,

(i) The requirement for banks not to tranche their exposures across different LTV buckets would have several negative consequences:

a. cliff effects would be created around the LTV thresholds as shown in the examples below:

LTV	**79%**	**80%**	**89%**	**90%**	**99%**	**100%**
Existing RW	35%	35%	39%	39%	43%	43%
Proposed RW*	40%	50%	50%	60%	60%	80%

*assuming DSC<35%

b. sharp increase of risk weights for LTVs above 80% where most of the market and certainly the market for first time buyers lies, which appears to contradict the stated objective of the Committee of not increasing overall capital levels

c. regulatory arbitrage opportunities would be opened: banks could extend several loans with different lien rankings based on the bucket thresholds, or a property purchase could be funded by several banks, on the basis of those same thresholds.

			DSC ≤ 35%							
			LTV = 30%	LTV = 40%	LTV = 50%	LTV = 60%	LTV = 70%	LTV = 80%	LTV = 90%	LTV = 100%
RW	One loan		**25%**	**30%**	**30%**	**40%**	**40%**	**50%**	**60%**	**80%**
	Combination of loans	0/40	25%	25%	25%	25%	25%	25%	25%	25%
		40/60		30%	30%	30%	30%	30%	30%	30%
		60/80				40%	40%	40%	40%	40%
		80/90						50%	50%	50%
		90/100								60%
		overall	**25%**	**27%**	**27%**	**30%**	**30%**	**32%**	**32%**	**35%**
RW gain when several loans vs. one loan			**0%**	**3%**	**3%**	**10%**	**10%**	**18%**	**28%**	**45%**

We therefore strongly believe that the same tranching approach as the one used today should prevail.

(ii) The consultation assumes that a valuation will always be available. In the majority of cases, the transaction price between buyer and seller is the best valuation one may hope for, which is why requiring a valuation for each and every retail mortgage loan is not market practice in France.

(iii) We do not understand the requirement for the property to be fully completed, given for example the protective environment available under VEFA or VIR in France (please refer to Annex 1), whereby a bank completion guarantee for the benefit of the acquirer/borrower is required from the outset.

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

Please refer to Annex 3.

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

As stated in Question 9, we believe there is a strong inconsistency of calibration in the proposed framework: if unsecured regulatory retail exposures are risk weighted at 75%, it would be inconsistent for exposures secured on property to reach levels above that, such as the 80% or 100% being proposed, depending on LTV and DSC. In addition, alternative risk drivers such as maturity, fixed-rate vs floating rate, and recovery procedures should be comprehensively considered.

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

Option B is more suitable. We believe that, as between the two commercial risk estate options, Option B is the more credible approach, as it incorporates the credit risk mitigation resulting from the real estate security interest.

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

Upon review of the Quantitative Impact Study relevant to commercial real estate, we believe the QIS introduces complexity, is not developed in accordance with the Committee's text and is ultimately not appropriate to the treatment of exposures on Commercial Real Estate.

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

No comment

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

The proposed changes could have implications on the leverage and large exposure calculation. Hence, the impact of the proposed changes to other Basel standards should be considered. Credit Conversion Factors ("CCF"): The revised framework on CCF rises

- **Technical guarantees:** The proposal to apply a 50% CCF to transaction-related contingent items such as performance bonds, bid bonds, warranties and stand by letter of credits appears to be penalizing and far from empirical evidence. Recently, the CCF on such transactions applicable under the IRBF framework has been reduced from 50% to 20%, reflecting the very low losses sustained by banks under those exposures. When we compare the 20% CCF with the results of our own back-testing, even the 20% CCF remains significantly above statistical evidence.

- **Commitments that the bank may cancel unconditionally :** The contemplated set up of a 10% CCF on such credit facilities raises the following concerns :

- the need to adapt accounting IT systems in order to take these uncommitted facilities into account will result in significant extra costs ;
- empirical evidence should be produced that shows that the 10% CCF is warranted on the basis of past credit history of this asset class ;
- the application of a CCF on such commitment will result in capital to be set aside against uncommitted credit facilities which, in turn, is likely to result in two reactions from the banks:
    - banks will have an incentive to reduce such undrawn, uncommitted facilities as much as possible ;
    - as the remaining part will generate cost of capital, it can be anticipated that banks will apply commitment fees in order to remunerate those facilities – in return, this provides the clients with an argument that the facility has to be maintained in case they need it, thus ***increasing*** the risk profile of the uncommitted lending activity.

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

We urge the Committee to consider the results of a survey conducted on Low Default Portfolios by the EBA in 2013 ("Interim results update of the EBA review of the consistency of risk-weighted assets", EBA, 5 August 2013), which concludes that CCF values appearing in the current legislation are adapted, and in line with the historical experience: "the foundation CCF is often used as a benchmark by the banks.".

We therefore consider that CCF levels submitted in the consultation are not adequately backed by evidence. In a nutshell:

- The 75% CCF for undrawn commitment is too high.
- The 10% CCF to unconditionally cancellable commitment to consumers seems too high, and does not reflect the riskless substance of the product.

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

No comment

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

No comment

Q21. What exposures would be classified under "Other assets"? Is a 100% risk weight appropriate? (Please provide evidence where possible).

No comment

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

The "Investment grade" concept based on the default risk assessment and estimated recovering, needs to be more precisely defined, as at this stage, the concept relies on a certain part of subjectivity. Therefore, for AIRB banks, it is a third way to assess the risk of a counterpart, which would complicate the risk analysis and the comparability. While we understand why the Committee would want to focus on guarantees, we believe that some of the operational requirements (article 128 (a) in particular) are too detailed and should be left to the local regulator to appreciate. Taking the example of French public sector guarantees, which are very prevalent in the social housing and associative sectors for instance, the requirement for the bank to "have the right to receive payments from the guarantor without first having to take legal action" would mean none of them can be recognized, which would be in blatant contradiction with the protection they have been shown to provide in case of financial difficulties. Not all guarantees will be first demand guarantees and the fact that they are first demand or not, are not the best way to approach their usefulness (e.g. sharp decline in the monoline guarantees business since the financial crisis).

We understand that, for the sake of simplicity, the credit risk SA since Basel I has not recognized physical collateral (except real estate) for regulatory capital purposes. If the new credit risk SA is aimed at being more risk sensitive, we believe that physical collateral should be recognized as a credit risk mitigant for secured transactions on corporates that do not qualify as specialized lending given the positive effect of such collateral on recovery rates in case of default. We believe collateral should be taken into account in the new credit risk SA without increasing complexity –for example by adjusting downwards corporate risk weights.

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

Considering all the remarks made above and especially the facts that risk drivers are not enough discriminant, we remain quite sceptical about replacing the external rating by an over-simplistic approach.

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

We would like to make a comment on the Committee's will to simplify the treatment of credit derivatives. We would like to remind the Committee that standard contracts for North American CDS do not specify restructuring as a credit event. Then, the restructuring requirement mentioned in section 3.4 of the consultative document would strongly disincentive banks to hedge their exposures on US names or force them to execute nonstandard CDS (i.e. including the restructuring clause) that will be both less liquid and non-eligible to clearing houses. While the mere fact that these contracts could not be settled through a clearing house seems contradictory to general regulatory willing in this extent, it can be underlined that according to market participants, no restructuring credit event occurred in the US since 2003, this kind of credit event being generally operated under chapter 11 bankruptcy filing.

ANNEX 1: A special focus on Real Estate development in France

How the legal environment of the Real Estate development is organized in France? What would be the impact of the proposed risk drivers on this economic sector?

1 - Development financing in France is strictly controlled by a set of legal rules

- In France, the Real Estate development activity is mainly done through the "VEFA" scheme ("Vente en état futur d'achèvement"). It is worth noting that such scheme is compulsory for the regulated residential segment.
- According to the paragraph 1601-3 of the Civil Code ("article 1er of the law n° 67.3 – January 3rd, 1967), "the VEFA is a contract under which the seller immediately transfers its property rights on the land and existing real estate assets to the buyer. The property rights on the buildings to be built are progressively being transferred to the buyer during the construction period; and the buyer is progressively paying the acquisition price during the said construction period".
- The French solicitors ("Notaires") prepare a VEFA contract between the seller and the buyer if and if only a GFA ("Garantie Financière d'Achèvement") is issued by a Bank or Insurance Company.

2 - In this legal context, Bank's responsibilities are important

- The Banks have to make sure that all funds coming from a development project (e.g.: sales/presales/reservations) will be only affected to the construction of the said project for which the Banks have specifically issued a GFA.
- In addition, they have to check that all invoices received and to be paid are strictly related to the different costs budgeted for the development project for which they have specifically issued a GFA.

To make sure that controls Banks are legally entitled to do are well monitored, they have in most cases recommended to their clients a legal segregation of each development project, though the setup of ad-hoc SPCs/SPvs.

Such SPVs can take various legal forms: SCI, SNC, SCCV etc… and can be used to isolate each development project and its dedicated in-flows (presales/reservations) and out-flows (construction costs, financing costs etc…).
In particular,

- The SCI ("Société Civile Immobilière") has a sole business purpose: to "insulate" a specific real estate project whether it is development or investment.
- The SCCV ("Société Civile de Construction Vente"), regulated by the July 16th, 1971 law, has a more specific business purpose: to develop a real estate asset in order to sell it to third parties (either in one block or by units). Worth to note that there is no minimal equity for such SPVs.

3 - French Developers have positively answered to the Banks recommendations

According to French Law, all flows associated to the same development project have to be segregated. There is a risk of penalty, if such rule is not strictly followed. Therefore, most French developers have started to isolate each of their development projects in dedicated SPVs.
Others continue to develop their projects directly on their balance sheet but it requires a very specific/expensive/complex analytical accounting organization to strictly follow each in-flow/out-flow of each project. Then a dedicated analytical report for each development project has to be sent to the Banks which have issued the related GFAs.

4 – Negative consequences of the application of the proposed RWs level to small SPVs/SPCs

The proposed RWs applied to small structures with two risk drivers based only on revenues and leverage would highly penalize the described development financing scheme in France, which is considered as one of the most secured ones in Europe and fully accepted/sponsored by the French regulator, the Banks and the developers.

If the bankers were to be penalized in terms of RWAs when they finance small structures with low revenues and equity, it would mean that they would

- Either not finance any more real estate development projects even though the residential sector is a key sector for the French government (500.000 dwellings to be built / year)
- Or require developers to develop all their projects on a corporate basis with the need to set up tight controls of all in and out flows implying highly expensive costs…

Conclusion

The current development financing scheme in place trough dedicated SPVs for each project has already shown its resilience/efficiency in terms of risk follow up (direct risk: project by project follow up and indirect risk: money laundering).

Challenging such ways of financing, because of the application of penalizing level of RWs, would certainly widely damage the financing of a key economic sector in France.

ANNEX 2: A special focus on trade & commodity finance[2]

Scope

This paper addresses the potential impact that the proposed revision to the Standardised Approach could have on Trade Finance and more specifically on Commodity Finance. Trade & Commodity Finance covers trade-related bank exposures such as Letters of Credit, surety bonds, and short-term loans. Commodity Finance makes use of Trade Finance products dedicated to the trading of commodities (oil products, metals, "soft", i.e. agricultural raw materials). Commodity Finance is an essential component in the functioning of a highly capital-intensive business which irrigates the whole world economy. It is mainly focused on very short-term transactions (e.g. the financing of a cargo of oil until it reaches its destination), which are deemed "self-liquidating" (per the example above, the financing is repaid from the proceeds of the sale of the cargo).

Summary

We do welcome the stated Committee objectives to seek convergence and enhanced comparability in RWAs between banks involved in this business, and that this be achieved in a simple and risk sensitive manner. However, we would like to express our deep concerns regarding the potential unintended consequences that the current proposals would have on the Trade Finance and Commodity Finance sectors. We focus in this response on the asset class Specialised Lending (SL), of which Commodity Finance is usually considered a subset. We disclose below aggregated high-level historical data in the area of Commodity Finance (evidencing its low-risk nature) and we propose simple alternatives recognising the specificities of Commodity Finance structures, which are far more risk sensitive than a simple two-financial-factors approach and/or a single risk weight/floor of 120%. These alternatives therefore more accurately reflect the true risks of Trade and Commodity Finance activities.

Ongoing dialogue after March 27th

Given the consultative nature of the current proposals and their estimated wide impact, an ongoing dialogue, through for example a technical meeting between the BCBS Task Force and the industry, would be very welcome in order to exchange knowledge on risk drivers and IRB modelling practices. Commodity Finance is sometimes incorrectly perceived to carry a higher level of risk because it is somewhat more complex than standard corporate lending. A quantitative industry survey evidencing the low risk nature of Commodity Finance could also be conducted in order to illustrate this point. This would be at a more granular level than the information presented in this response and hence more time would be needed to collect historical data in a consistent manner from participating banks.

1. General comments

Proposed capital floors (whether on Specialized Lending or more globally between AIRB and Standard Approach) are to the detriment of low-risk businesses, such as Commodity Finance.

Furthermore, it is clear for banks involved in this business that these floors actually have the undesirable effect of reducing risk sensitivity. In particular, they demean the value of structure and reduce the benefit of taking collateral and other forms of security.

[2] This annex was jointly drafted by Dutch and French banks.

Capital floors, if set at an artificially and unnecessarily high level will thus give wrong incentives to banks that currently have higher quality Commodity Finance portfolios. Floors create the unintended opposite effect for banks to engage in higher margin business (read: higher risk), lending to weaker counterparties for which higher margins can be charged. This, in order to compensate for the higher capital charge required to meet the return on equity targets. Furthermore, the cost of borrowing for most Commodity Finance clients could significantly rise, thus ultimately reducing the availability of liquidity in the international trade finance market.

We believe it is important to maintain the risk sensitivity of internal risk management tools developed by Commodity Finance banks who have each made substantial investments in AIRB models to provide competitive financing for this essential sector of the economy.

2. Specialised Lending (SL)

A granular approach for SL is necessary to improve risk sensitivity

Specialised Lending includes a broad range of financing types, such as Commodity Finance, Project finance (including Mining and Reserves), Object Finance (such as Shipping and Aircraft), and Commercial Real Estate Finance, all with their specific characteristics and risk profile, hence the design of the AIRB framework distinguishes among these different types. We believe the same granularity in the treatment of SL should be inserted in the current consultative papers, in order to achieve and to maintain enhanced risk sensitivity.

The accumulated experience in developing AIRB models must be taken into account

Commodity Finance banks can demonstrate a track record of low losses over time, including a full economic cycle. The historical evidence has in fact already been applied in annual reviews of internal models, where back-testing is an important part of the analysis, and for which regulatory approval has been obtained (although it is recognised that because only a few banks have invested in developing such Trade Finance and Commodity Finance models, industry practices might not be well spread as yet).

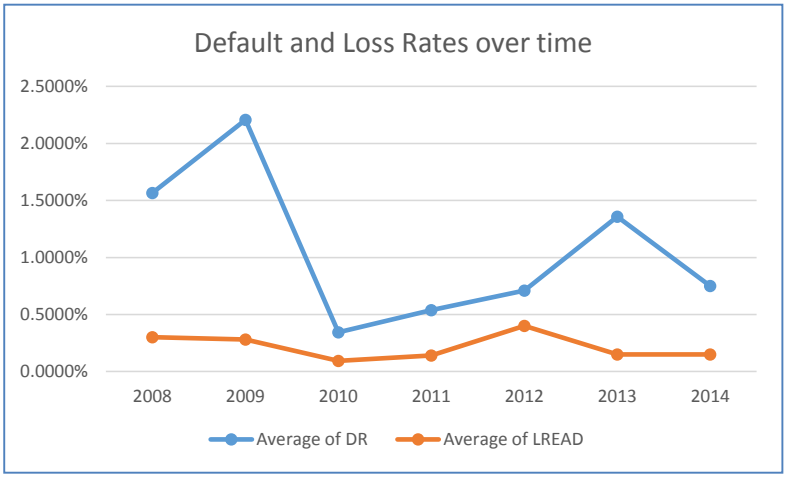
The value of structure and collateral in Specialised Lending must be recognized

The Standardised Approach is borrower specific and does not take into account the structure, collateral and other security types. This extremely narrow approach effectively penalises sound business models such as Commodity Finance, which are all important for the real economy, even to the point that banks will have to consider carefully whether some of these businesses will remain economically viable under the new proposals.

3. Commodity Finance

Low risk evidenced by historical data

Anonymously aggregated high-level historical data by six French and Dutch banks actively involved in Trade and Commodity Finance clearly evidences the low-risk nature of Commodity Finance. These facts clearly reinforce the need for a more risk sensitive calibration for Commodity Finance, which would take into account the specific risk mitigants involved, and their proven historical effectiveness. In particular, observed default rates (ODFs) and loss rates (compared to EAD and exposures) have been collected over the period 2008-2014, see graph below.



The average default rate is estimated at 1.01% while the average loss rate is 0.21% on EAD (and even 0.14% when compared to exposures). Indicative and conservative estimates of implied risk weights, using this average default rate and the highest loss rate observed (2012), are much lower than the currently proposed 120% for Specialised Lending (55% with a maturity of one year, and 69% with a maturity of 2,5 years, while most commodity Finance exposures are even shorter than one year). A technical meeting with the Committee where the observed loss data and resulting risk weights would be discussed in more depth, will in our opinion provide a deeper understanding.

Leverage and revenue not risk sensitive for commodity traders and even lead to capital volatility

While some leverage ratios (however different from the one currently proposed) and revenues (although not as an absolute figure among all borrowers) may sometimes be considered to be relevant drivers in the quantitative component of certain corporate models, this is certainly not true for counterparties active in commodities. Instead, gross margins, solvency and liquidity factors, averaged over a multiyear period, are far more useful indicators. More importantly, leverage and revenues are considered not risk sensitive for counterparties involved in commodity trade, since there is no risk differentiation through leverage (all are indeed rather similar) and the revenues are volatile as they mostly depend on (variations in) commodity price levels. Moreover, the qualitative component remains extremely important for a forward-looking view, e.g. for commodity traders the quality of management, risk management sophistication, trading practices and hedge methodology have proved to be important factors. Therefore, finding a simple and risk sensitive approach for commodity traders is challenging, but should at least revolve around the above mentioned financial factors instead of those currently proposed (or even a single risk weight/floor of 120%).

Alternatives for Commodity Finance structures

No recognition is given in the current proposals for the short-term, uncommitted and trade-related nature of Trade Finance and Commodity Finance exposures. Trade financings are mostly self-liquidating in nature and truly short-term, i.e. 30 to 90 days. In addition, deals are typically secured by very good quality collateral, such as commodities for which liquid terminal markets exist, or Receivables.

We recommend introducing alternatives to the current proposal, and in particular to consider for instance:

- Specific risk weights by subcategory within SL, taking into account structure/collateral specific elements. For example, in cases where more than 100% commodity collateral is present;
- Recognition of non-financial collateral through the existing Credit Risk Mitigation framework. For example, liquid and exchange-tradable (hence with an objective valuation) commodities could be recognised in a similar way as gold;
- Define at least specific lower floors, when a strong structure/collateral is present.

ANNEX 3: A special focus on Residential Real Estate in France

Context

In France, most residential property loans are guaranteed by companies specialised in this activity (61 % of total in 2011 and 65 % in 2012)[3]. This system brings as much security as mortgage loans ("mortgage insurance") and provides a total cover of the real-estate loan in terms of credit risk. These guarantee companies are approved by the National Competent Authority (ACPR in France) and are specialised in this kind of protection.

The development of this practice results from the advantage it presents from the point of view of both lenders and borrowers. On the lender side, it guarantees a second analysis, independent from internal analysis realised by credit institutions and the coverage of the non-payments. For the borrower, it provides an alternative to the French mortgage system and is both less costly and less time consuming. If the borrower fails, the mutual guarantee is more secure and less expensive for the credit institution. Every borrower pays a premium for the mutual implementation. This diversified and united system, available in all the French territory, permits a risk mutualisation.

Mortgage loans and guaranteed loans are therefore very similar from a risk standpoint: a guaranteed loan is ultimately backed by a promise to mortgage (“promesse d’hypothèque) in the event the mortgage insurer defaults.

Consequently, guaranteed loans and mortgage loans are totally equivalent. Any differentiated treatment between mortgage loans and guaranteed loans makes even less sense if one considers that the features of both types of loans are completely similar in terms of maturity and liquidity matching.

The guaranteed loan system is very secure, as stated within the Country report n°11/211 of the International Monetary Fund (July 2011), the EBA’s Fourth report on the consistency of risk weighted assets (RWAs) in the residential mortgage portfolio (June 2014), and the Annual survey of residential financing published by ACPR. In addition the Joint Forum clearly acknowledged the soundness of the French guaranteed loan system in its August 2013 document on mortgage insurance.

Residential property loans constitute an intrinsically low-risk market. The selection of risks and the decision to lend are driven on the analysis of the borrower’s profile (prior ability to save and to sustain repayment of the loan, job stability, age, family situation…). The in-depth analysis of the borrower’s solvency is supplemented by an assessment of the effectiveness of risk coverage in the event of default by the borrower’s assets – capacity to recover the loan from not only real estate but all the borrower’s assets - or the borrower’s death or incapacity – by a death and total invalidity insurance policy.

[3] The real-estate market is characterized by important and strong actors. Crédit Logement is the main actor with a market share estimated at 35 % on all the distributed credits.

Therefore, as evidenced by legal and prudential homogenous treatment, and historical experiences highlighted above, we consider French guaranteed loans equivalent to mortgage loans.

Impact on NSFR calculations

On the basis of the above rationale, we would like to take this opportunity to remind the Committee that the future regulatory treatment of real estate loans backed by a guarantee will also have an impact on the NSFR computation.

Given that according to currently applicable regulatory texts, a 35% Risk Weight threshold is the upper limit in order to benefit from a required stable funding ratio of 65%, we therefore consider that mortgage loans benefitting from a guarantee deserve the same favourable NSFR treatment.

Summary of proposals

- Homogenous treatment of real estate exposures irrespective local legal framework:
    - The "retail mortgage" portfolio should include exposures on residential real estate
    - Residential real estate exposures should be defined on the basis of financing objective (residential real estate) and not on the basis of the guarantee used
    - Mortgages are only a subset of this portfolio
    - Based on national best practices, different guarantees can be used, for example the "caution". These should all be included within the "retail mortgage" portfolio
- Residential real estate in France will always benefit from a guarantee
    - The Basel Committee proposal (page 36, annex 1) is overly conservative, inasmuch it applies risk weight above 75% to all exposures irrespective of the existence of a guarantee
    - The standardised approach applicable to residential real estate risk should include more instance in which RWA would fall under 35% on the basis for example of LTV below 80%.
- Risk drivers
    - We are in favour of LTV coupled with DSC ratio
    - DSC ratio should distinguish 5 risk buckets that ensure the homogeneity of treatment across credit institutions
    - We would like to point out that the Joint Forum recommendations concerning "Credit risk management across sectors" (consultative document of February 2015) highlight the resilience of the French real estate market given the importance of lenders' solvency and the existence of insurance guarantees
    - Besides, if one sets aside subprime lending in the US and specific pockets in Europe such as part of the Irish market or UK subprime, we cannot think of any meaningful jurisdiction where the financial crisis would have exposed the existing calibration as not being prudent (page 15 of the consultation). Even in countries such as Spain that did suffer an extensive real estate crisis, retail mortgage loans haven't generated high levels of losses. It therefore appears extreme to amend an international calibration in order to solve a localized issue.