GE Capital

901 Main Avenue
Suite 800
Norwalk, CT 06851
USA

T +1 203 840 6300

March 27, 2015

Basel Committee on Banking Supervision
Centralbahnplatz 2
4051 Basel
Switzerland

Ladies and Gentlemen:

General Electric Capital Corporation ("*GECC*")[1] welcomes the opportunity to comment on the Basel Committee on Banking Supervision's ("*Committee*") consultative document, published for comment in December 2014 and entitled *Revisions to the Standardized Approach for credit risk* (the "*Consultative Document*"). The Consultative Document sets forth the Committee's early thoughts[2] on proposed revisions (the "*Proposal*") to the current standardized approach for credit risk.[3]

---

1 GECC is a wholly-owned subsidiary of General Electric Company and offers a diversified range of financing alternatives and financial services to commercial and consumer customers. On November 25, 2014, the Board of Governors of the Federal Reserve System (the "*Federal Reserve*) proposed for comment enhanced prudential regulatory standards that would apply to GECC, including the standardized approach (but not advanced approaches) of the Federal Reserve risk-based capital rules applicable to bank holding companies.

2 The Committee notes that the Proposal is "at an early stage of development" and that Sections 1 and 2 "introduce the proposals as developed to date." Consultative Document, pp.1 and 2.

3 Committee, *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version* (June 2006).

Notwithstanding that the U.S. banking agencies only recently adopted a revised standardized approach to credit risk in their risk-based capital regulations,[4] we agree with the Committee's view that this is an appropriate time to revisit and improve the Committee's standardized approach. We have worked closely with the Institute of International Finance (the "*IIF*") in reviewing the Proposal and generally support the views expressed in the IIF's comment letter. Among the aspects of the Proposal discussed in the IIF letter, three are particularly important to us – namely:

- the Proposal's failure to recognize the contribution of non-financial and non-real estate collateral to reducing lenders' loss given default ("*LGD*") and, accordingly, the benefit of such collateral as a key input in determining the risk weight for secured corporate exposures;
- the Proposal's application to specialized lending exposures of a risk weight that is the higher of (i) the counterparty risk weight (determined on the basis of the counterparty's revenue and leverage applying the matrix included in the Proposal) and (ii) 120% or 150%, depending upon the nature of the specialized lending exposure; and
- the Proposal's application of a uniform 75% credit conversion factor ("*CCF*") to commitments that are not unconditionally cancellable, irrespective of the maturity.

The Committee indicates in Section 4[5] that it will conduct a QIS to further inform the Committee's design and calibration of the standardized approach, including as a capital floor to IRB models.[6] We urge the Committee, as part of that QIS, to develop empirical bases for determining (i) whether non-financial and non-real estate collateral reduces LGD in a manner that warrants giving some credit to such collateral as a risk mitigant, (ii) the appropriate risk-weighting or weightings of specialized lending exposures, and (iii) whether the Proposal's 75% CCF for commitments that are not unconditionally cancellable is too high when considered against actual experience. It is important that the Committee's empirical analyses be made available in connection with any reproposal for consideration by interested parties.

---

4 The Federal Reserve and other U.S. banking agencies adopted Basel III-based revisions to their capital rules in July 2013. The Basel II-based standardized approach to risk-based capital in those revised capital rules first became applicable to covered institutions on January 1, 2015.

5 Section references in this letter are to sections of the Consultative Document.

6 Committee, *Consultative Document – Standards – Capital floors: the design of a framework based on standardised approaches (Dec. 2014).*

We generally support the seven Principles outlined in Section 1.3 of the Proposal and agree that a revised standardized approach must "remain both simple and practicable." [7] We are committed to working with the Committee to craft provisions for a revised standardized approach that address these issues in an empirically based manner but that is also consistent with the seven Principles. Procedurally, we believe the process of working towards final revisions to the standardized approach must be iterative and that the Committee should publish for further comment a revised Proposal once an empirical basis for its calibration is developed.

I. A revised standardized approach should recognize that some types of non-financial instrument collateral and non-real estate collateral are risk mitigants that warrant lower risk weightings than would apply based simply on the risk weighting of the corporate borrower.

The Basel Committee's standardized approach has not traditionally recognized non-financial collateral as a risk mitigant, other than in limited circumstances residential real estate. However, consistent with the Committee's objective of "increasing risk sensitivity,"[8] we believe that this is an appropriate time for the Committee to reconsider the risk mitigation benefits of non-financial and non-real estate collateral for two reasons. First, and central to the purpose of regulatory capital requirements, in many circumstances a lower risk weighting should be assigned to secured as compared to unsecured corporate exposures because the collateral actually does reduce risk. As a baseline observation, there can be no question but that, all else being equal, a perfected first priority security interest in collateral will reduce the lender's exposure and, in the case of default, increase its recovery rate. Standard & Poor's, in a recent report evaluating recoveries on secured versus unsecured exposures in the post-recession period (2010-2013), noted that, "while revolving credit facilities, first-lien term loans, and secured bonds have experienced higher-than-average recoveries in recent years, relatively less-senior instruments such as second-lien term loans, senior unsecured bonds, and subordinated bonds have experienced lower-than-average recoveries."[9]

---

7 Consultative Document, p.4.

8 Consultative Document, p. 1.

9 Standard & Poor's Ratings Services, RatingsDirect®, *Default, Transition, and Recovery: Recovery Study (U.S.): Are Second Liens and Senior Unsecured Bonds Losing Ground as Recoveries Climb?* (Dec. 16,

Second, and important from a policy perspective even if not central to the purpose of regulatory capital requirements, recognition of collateral benefits with lower risk-weights, where appropriate, is particularly important to small businesses and other middle market borrowers. These borrowers are more likely to be able to borrow only on a secured basis. If a lender's risk-weighting for these exposures is based only on the Proposal's revenue and leverage matrix, the risk-weighting for these exposures is likely to be higher than for larger more established borrowers notwithstanding that, once collateral is recognized, the actual risk in the exposures to these middle market borrowers is likely lower. Moreover, making credit available to these borrowers is particularly important as a driver of economic growth.[10], [11]

We recognize the challenge in formulating simple standards that incorporate the risk mitigating benefits of a wider range of collateral. However, we believe that the Committee, national regulators and the industry can work together to develop a standardized approach that is risk sensitive, but without the complexity of the IRB treatment of collateral.

Preliminarily:

- given the need for simplicity in the standardized approach, only collateral types that have recognized liquidity and ascertainable value should be recognized. For example, customer receivables and inventory and airplanes in corporate fleets meet these standards;

2013), p.1 (where the authors' analysis showed 70% recovery rates for term loans with a first lien compared to a 40% recovery rate for senior unsecured bonds).

[10] European Commission, Annual Report on European SMEs 2013/2014 – A Partial and Fragile Recovery (July 2014), p.14 Small and Medium-sized Enterprises (SMEs) are defined as businesses which employ less than 250 staff and have an annual turnover of less than €50 million and / or their balance sheet total is less than €43 million. SMEs accounted for 99.8% of all enterprises active in the EU28 nonfinancial business sector, 66.8% of total employment, and 58.1% of the value added – defined as the difference between economic output and intermediate consumption of this sector. p.6 – Adopted in 2008, the Small Business Act for Europe (SBA) reflects the importance of SMEs to the European economy and establishes a comprehensive SME policy framework for the EU Member States, including improved access to financing. p.33 – In general, those countries with high SBA implementation status have also demonstrated strong economic performance with moderate to strong growth.

[11] U.S. Small Business Administration (SBA), *Advocacy: the voice of small business in government – Frequently Asked Questions.* (March 2014), p.1 Small business is defined as an independent business with less than 500 employees. Small businesses make up: 99.7% of U.S. employer firms, 48.5% of private-sector employment, and 46% of private-sector output. Small businesses accounted for 63% of the net new jobs created between 1993 and mid-2013.

- only collateral securing a first lien should be eligible as a risk mitigant; and

- the lender should be entitled to recognize the collateral as a risk mitigant only if the lender evaluates the collateral frequently (at a minimum, once every year),[12] and has determined as of the most recent collateral evaluation that its exposure is fully secured.

As to how the risk mitigation benefits of eligible collateral are recognized, we suggest that the Committee consider implementing risk mitigation as a simple and straightforward, and uniform, reduction to the risk-weighting that would otherwise apply on an unsecured basis. As to what the reduction should be, we urge the Committee, as part of its QIS or other empirical studies, to analyze losses and recovery rates comparing secured loans that satisfy the standards suggested above versus unsecured loans. Assuming (as we anticipate) that the empirical analysis shows lower losses and higher recovery rates for secured loans meeting those standards as compared to unsecured loans, we urge the Committee to identify an appropriate but conservative reduction in the otherwise applicable risk-weighting that gives effect to the benefits of collateral.

II. Some types of specialized lending exhibit lower risk and losses than either (i) other types of specialized lending or (ii) ordinary non-specialized corporate lending. It is important to the borrowers and projects categorized as specialized lending, and to the lenders that provide specialized lending facilities, that any final revisions to the standardized approach recognize differences between types of specialized lending and gradations of risk and losses.

A. Background and Assumptions

The Committee's current standardized approach does not separately or specifically address specialized lending. The Proposal, for the first time, would identify specialized lending as a subset of corporate lending with a separate and specific treatment for standardized approach purposes. The Proposal would apply a risk weight that is the higher of (i) the counterparty risk weight (determined on the basis of the counterparty's revenue and leverage applying the matrix included in the Proposal) or (ii) either 120% (in the case of project finance exposures) or 150% (in the case of land acquisition, development and construction finance

---

12 This is consistent with paragraph 509 of Basel II.

exposures). The Committee comments that it has adopted this straightforward approach "[f]or simplicity".[13]

The Proposal states that specialized lending "generally exhibits higher risk and losses than other types of corporate lending" and recites that "[e]mpirical evidence" supports that assumption. The Proposal does not cite or discuss the empirical evidence on which it is relying. Specialized lending, as defined in the Proposal, encompasses a broad scope of transaction types. While it may be the case that some specialized lending transactions exhibit higher risk and losses than general corporate lending, this is certainly not always the case. Due to the nature of specialized lending it is very hard to generalize as the risk will be highly transaction specific. This variability in the risk at the transaction level supports the argument for a more granular and risk sensitive framework.

Our experience is that specialized lending in the categories of project finance (in our case almost exclusively for infrastructure projects), object finance, and income producing real estate is among the safest forms of lending. The reason this type of specialized lending is safe is inherent in the nature of the transactions GECC originate. Because of our extensive experience in these lending types and our rigorous underwriting criteria, GECC is able to manage these portfolios to very high credit quality standards resulting in low losses and risk by ensuring that repayments are well covered by predictable cash-flows and the asset backing is strong and easily recoverable.

B. Framework for an Approach to Specialized Lending

Given that not all types of specialized lending are equal, and this has been recognized in the advanced approaches, we urge the Committee to consider a "slotting" approach for the standardized approach's treatment of specialized lending a framework.[14] The components of such an approach could include the creation of five categories from strong to

---

13 Proposal § 2.2.2.

14 We believe an approach similar to that used in the Basel II IRB for specialized lending exposures would be more appropriate. This would also fulfil the stated intention to increase comparability and alignment with the IRB approaches.

default[15] with the slotting among the five categories pursuant to a matrix of factors (yet to be developed)[16] with an associated range of risk weights.[17]

We realize that implementation of a slotting approach may not be as simple as the Proposal's approach. However, we also believe that, with further attention by the industry and regulators, a more refined approach than currently proposed can and should be developed.

III. We believe the Proposal's 75% CCF for unconditionally cancellable commitments regardless of maturity is too high and, depending upon the outcome of the Committee's QIS or other empirical analyses yet to be undertaken, likely should be in the range of 40% to 50%.

The Proposal would increase the standardized approach's CCFs for commitments that are not unconditionally cancellable from the current treatment of a 20% CCF for commitments with an original maturity up to one year and a 50% CCF for commitments with an original maturity over one year to a 75% CCF irrespective of maturity.[18] We disagree with the Proposal's change in the CCFs for commitments that are not unconditionally cancellable and have three core observations as to why the increased treatment is not warranted.

First, draw-down experience on commitments across credit cycles is a topic that can be analyzed empirically. We urge the Committee, as part of its QIS or other empirical studies, to analyze whether the proposed change in the standardized approach's CCFs is warranted and to make a change only if supported by empirical analysis.

Second, although as indicated above we think that an empirical analysis designed to address this specific feature of the standardized approach is necessary, a variety of studies have been undertaken over the years analyzing draw-down experience on committed facilities. None that we are aware of, however, are sufficiently targeted and on point to, alone, support

15 See Paragraph 275 of Basel II

16 See Paragraph 276 of Basel II

17 See Paragraph 275 of Basel II. However, the risk weights used for the Proposal should be based on empirical analysis yet to be undertaken.

18 The proposal would conform the standardized approach's CCFs for commitments to the foundation IRB's CCFs for commitments.

either changing or retaining the current CCFs. Most recently, a paper prepared by staff in the Office of the Comptroller of the Currency analyzed approximately 1,900 SNC facilities between 1997 and 2009 and measured additional drawdowns over the pre-default observation period as a percentage of unused credit limit, which is equivalent to the regulatory CCF measure. The study found that credit lines with a current utilization greater than 90% have an average CCF of 0% and that credit lines with a 0% current utilization have an average CCF of approximately 35% for obligors rated "Special Mention" and approximately 43% for obligors rated "Pass"; supporting that empirical rates are much lower than the proposed CCF and even somewhat lower than the current CCFs.[19]

Third, we do not want to prejudge whether maturity should be considered in determining an appropriate CCF and believe this would be derived from empirical analysis performed by the committee. However, if our expectation that draw-down rates on shorter-term facilities are lower than on longer-term facilities, applying a uniform CCF to committed facilities irrespective of maturity is not risk sensitive and creates an incentive to issue commitments for longer periods – an incentive that, unless supported by an empirical analysis of actual behavior, should be disfavored as compared to the existing standardized approach's treatment that provides an incentive to make shorter-term commitments.

For the foregoing reasons, we urge the Committee to reconsider the Proposal's change in CCFs for committed facilities. Although we agree that the CCFs for committed facilities in the standardized approach and the foundation IRB approach should be conformed (seeing no logical reason for different CCFs in the two approaches), any change bringing them into conformity should be empirically-based.

* * *

We appreciate the Committee's consideration of our comments and look forward to assisting the Committee in developing revised proposed amendments to the standardized approach that are grounded in empirical analysis and, in the case of our three major issues addressed in this letter, more accurately give effect to the risk characteristics of specialized

---

19 Irina Barakova and Harini Parthasarthy, *Model and Corporate Exposure at Default* (March 2013).

lending and other collateralized exposures and realistic expectations with respect to draw-downs on commitments that are not unconditionally cancellable.

Very truly yours,

Ryan Zanin

Ryan A. Zanin
Vice President & Chief Risk Officer, GE Capital