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Dear Sir/Madam:

Revisions to the Standardised Approach for credit risk

The IBFed appreciates this opportunity to comment on the Basel Committee on Banking Supervision (BCBS) proposal to revise the Basel Committee's standardised approach to credit risk and share with you our views. Before answering the Committee's specific questions we provide some high level messages on the consultative document.

We support a more risk sensitive approach to drive comparability

We understand and support the need for a more risk sensitive approach to the calculation of capital requirements for credit risk exposures to aid comparability, but are concerned that the new proposals seek to deliver a one size fits all approach, without recognising that exposures in the same asset classes can behave differently in different jurisdictions, because of the operation of national law, accounting approaches or market conditions.

The impact of the changes will be wide ranging

The impact of the proposed revised standardised approach will be very wide ranging requiring banks, we intuitively believe, to hold significantly higher levels of capital across the whole range of asset classes which will cause them to re-assess their business models,

perhaps withdrawing from lending to elements of their current customer base that are more capital intensive but nonetheless important to society as a whole.

Credit ratings continue to have a role

We do not support the complete removal of the ability for banks to take external credit ratings into account. For the majority of asset classes external ratings performed as expected as a rank-ordering predictor of default. They draw on a much wider range of factors than the Basel Committee is proposing. Whilst agreeing that banks should not mechanistically rely on ratings, we believe the ability to use them as part of their overall credit risk assessment process should be retained and permitted going forward.

The proposed changes are too important to be rushed

We are concerned that the Basel Committee is seeking to finalise its proposals within twelve months which we believe is too short a time frame for such a wide ranging revision. It will be important that the Basel Committee undertakes a series of quantitative impact studies (QIS) of the proposals impacts. We urge the Basel Committee to continue to engage with the banking industry and other interested stakeholders after considering the preliminary comments received and the results of the QIS in order to refine the approach and conduct further QIS.

In the attached annex we provide our responses to the questions contained in the consultation paper.

We thank you for taking our comments into consideration, and we look forward to future discussions on these issues.

Yours sincerely,



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Managing Director
IBFed



Debbie Crossman
Acting Chair
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Annex

Exposures to banks

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?

We believe that CET1 is higher quality loss absorbing capital and represents confidence that a bank is likely to remain a going concern but total capital is a better prediction of whether a senior bank creditor is exposed to loss. We do agree that CET1 would be an appropriate measure for the probability of default of banks. Given the options presented, we note that most banks are now generally managing to CET1 and publically disclose that figure.

Nevertheless, we have a number of concerns with the choices that are presented as noted below.

- Common equity and Tier 1 ratios are comparable and highly correlated. While these ratios indicate capital adequacy, they are bank-managed ratios that do not change materially in most cases and may not be sufficiently sensitive (particularly when some weak institutions may be required by their regulators to add capital).
- Use of the CET1 ratio appears to violate the proposal's own principle of not relying on internal modelled approaches to set capital charges (principle 4 in section 1.3) although we view this as a pragmatic choice.
- Capital ratios are known to be slow to fully reflect realities and are backward-looking. Many bank failures in the financial crisis were not correlated with weak capital ratios. It is well known that five days before its bankruptcy Lehman had a Tier 1 ratio of 11%.
- Applying the proposed risk drivers on banks that are not subject to Basel III makes the framework biased against banks in emerging markets as they are primarily not on Basel III and would thus be subject to the punitive 300% risk weight.
- It is difficult to accept that the CET1 ratio and NPA ratio by themselves are superior to credit ratings (despite their past failures in relation to structured products, although not generally in relation to their assessment of banks themselves.). Banks' capital ratios and NPA ratios are only one element of a credit rating agency's overall analysis. They take into account other indicators/factors that affect banks' ability to re-pay their obligations such as their leverage, liquidity position, business mix/model, economic cycle/outlook, market indicators (stock price, credit spreads), sovereign/political/legal/reputational risk, management strength and so on, that are not considered as part of CET1 and NPA ratios.
- So replacing external ratings with the proposed risk drivers will result in a loss of information and actually reduce risk sensitivity, contrary to the Committee's intent. There are many factors including capital adequacy that are included in external and internal credit ratings that should be considered.
- Solvency ratios may not be predictive of risk. Strong solvency ratios could be indicative of increased upside volatility in business results and/or, local regulatory requirements and not indicative of long term success. Using CET1 as an input to our RWA calculation is directly procyclical due to credit migration, impacts from lower earnings, etc.
- Use of a CET1 ratio is complicated because not all jurisdictions are on Basel III and in these instances it is just not possible for banks to calculate another Bank's pro-forma ratio since RWA varies (Basel I vs. III) but certain deductions do not appear in published financial statements – for

instance fair value of changes in own credit worthiness, deferred tax assets on a gross basis, investments in financial institutions greater than 10% among others. An alternative would be for counterparties to provide CET1 ratios to a central registry, conforming with universally applicable disclosure standards, aligned to Basel III subject to suitable controls. This would provide a consistent source for CET1 ratios for all banks to use.

- The method should not mix the use of Basel II Tier 1 ratios for some jurisdictions and Basel III Tier 1 ratios for others. There needs to be a common regulatory capital ratio across all jurisdictions; otherwise, an alternative more consistently calculated driver/metric should be chosen.
- Requirements that CET1 be at the legal entity level are impractical. Many entities are wholly owned. Ratios are not publicly disclosed. Local entity ratios are more likely based on a derivation of Basel I requirements. If chosen, we recommend that CET1 at the consolidated level be used.

We agree that Basel III rules (with full transition) should be applied for consistency across jurisdictions. For jurisdictions that are not yet subject to Basel III, a default risk-weight could possibly be considered. A secondary set of weights could also be used if the Leverage ratio needs to be used instead of CET1 for such banks.

Clarification is requested on whether the CET1 ratio used would be the capital floor adjusted CET1 or not, given the new rules proposed for capital floors.

We agree that the ratio calculation should align with the Basel III disclosure requirement such that it is readily available and consistently calculated by the subject obligor bank. This however will be problematic for banks that are not subject to Pillar III disclosure.

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?

We believe that the net NPA ratio is just one measure amongst others to assess credit risk and we are concerned that the definition for the calculation is neither simple nor likely to be consistently applied by reporting banks. It is also in our view pro-cyclical. As a result, we strongly recommend that external ratings for bank exposures be retained. Alternatively another asset quality measure similar to NPA such as Provisions/Loans may also be more readily available and useful.

Other concerns that we have with the net NPA ratio include:

- The practicality of maintaining constant awareness of when our obligors have breached any binding minimum prudential standard in order to apply the 300% risk-weight. If so national supervisors should be responsible for compiling a list of such banks in its jurisdiction; and these lists could be centralised at the BIS level. At the same time, publishing such lists could have other unintended consequences.
- The NPA ratio may be an indicative measure of loan quality, but for banks with large securities operations, this could be inadequate and misleading. Such banks may not have large portfolios of loans to make the NPA ratio an effective measure.
- Net NPA ratio for a bank could also be volatile from quarter to quarter, causing instability in risk weight measurement.

- The NPA ratio can be greatly influenced by portfolio growth/acquisitions and accounting changes such as IFRS 9. The definition of non-performing loans does not seem consistent with accounting standards (IAS-39/IFRS 9) and several terms in the definition would need to be more precisely defined (example: 90 days past due can be interpreted in different ways, for instance the precise point at which default is recognised).

There is also some inherent circularity in using NPA which would already be captured in capital and leverage ratios. For example, higher non-performing loans would result in higher RWA and lower equity to support RWA, via a slower increase or decrease in retained earnings. At the same time, a firm with low leverage but a higher NPA may not be as risky as less levered banks would experience slower rates of decrease in CET1 during a downturn.

We would also request further clarification on the consistency between the definition of non-performing assets for the net NPA ratio calculation and the Basel II definition of default for IRB approach (Basel II paragraph 452-457).

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

We agree that short-term interbank exposures should receive preferential treatment. But imposing a risk weight floor of 30% could be overly conservative and contrary to a risk sensitive approach. A floor of 30% is considered too high for high quality short-term interbank claims, and the reduction should be more than 20%, or these exposures should be rated based on risk categories (e.g. up to 10% for investment grade equivalent claims, 20% for non-investment equivalent).

We also note that short-term claims that are expected to be rolled over for liquidity purposes would not receive preferential treatment. The guidance ignores the intent of management and the impact on the market including a high likelihood of regulatory arbitrage. We believe this unduly increases the risk-weight of these exposures even though other Basel frameworks suggest the maintenance of highly liquid assets is required. We recommend that the wording “expected to be rolled over” be removed from p. 9 of the consultative document). We also believe that short-term interbank claims should be defined on the basis of residual maturity and not original maturity as any short term claim has the reduced risk.

We also have following questions:

- Are claims with no explicit maturity to be treated as short term?
- Why should this benefit be restricted to obligors that would otherwise receive <100% risk weighting?
- The duration of other exposures (e.g. corporates) is also a relevant risk factor and should be considered.

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?

One alternative would be retaining external credit ratings and sovereign ratings for Bank exposures, which may be used together with a metric based on ratios.

In our experience a range of financial metrics have value when assessing credit risk of a bank, supported by a sovereign/country risk assessment. Country risk could be included as sovereign integrity. For instance the existence of a legal architecture which supports fair and effective no-

creditor-worse-off resolution mechanisms could be supporting factor. To the extent it still exists in some countries implicit government support could also be a further supporting factor although we wish to emphasise that we fully support international initiatives that remove tax payer backed moral hazard. If agency ratings continue to be permitted for sovereigns, there will also be disconnect with bank risk weights that are based on other drivers. If the Committee is considering taking into account the country of risk as an additional risk driver, clarification would be required for the treatment of subsidiaries that do not report the required risk drivers and that are based in a different country than that of the parent.

Exposures to corporates

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?

We have the following comments/concerns regarding the use of the two proposed risk drivers for corporate exposures:

1. Using only revenue and leverage is too limited and could misrepresent credit risk. Unlike bank exposures, corporate exposures are driven by many more factors such as industry and region of activity. These factors, along with the financial factors such as revenue and leverage, are used extensively for credit rating analysis in the IRB approach. By removing the role of external credit ratings, the risk sensitivity to these factors will be lost.
2. The two ratios suggested fail to differentiate between different types of business (i.e. Agriculture/Service/Manufacturing). These ratios vary greatly between different sectors. Ratios may also not be available or stored in information systems for smaller corporates. This would automatically penalise the risk weight associated with unrated corporates.
3. It is nigh on impossible to develop 2-ratio metrics that work for all corporates around the globe due to material differences of industry, jurisdiction, accounting practices, foreign exchange volatility and numerous company-specific issues (e.g. significant ratio changes in their latest reporting or that are expected due to an acquisition). One of the key issues will be different accounting standards by jurisdiction that can result in differences in calculated leverage ratios (or other financial ratios) that are not reflective of differences in risks.
4. Leverage can vary significantly and systematically across jurisdictions and sectors. While obligors in some industries (e.g. regulated utilities) typically perform well with highly leveraged balance sheets, in other industries this is a sign of deteriorating credit quality.
 5. The proposed 300% risk weight for corporate borrowers that have not provided its financial information is punitive. Financial statements are not requested (or may not be provided by the borrower) for a number of reasons including strength of collateral (for example liquid secured facilities), type of borrower (small business, agriculture) or nature of the loan and jurisdictional non-requirements. Such a threshold might be the appropriate long term approach to encourage proper risk based data collection which we support. If this threshold is retained it should be phased in over a multi-year period.
6. We believe the treatment of investment funds exposures is inappropriate. Loans to investment funds should not be treated as corporate exposures. The information required for corporate exposures is not relevant for investment funds and results in treating these exposures with a 300% risk weight which is not appropriate. Possible alternatives to the revenue metric for funds may be “assets under management” by the fund or net asset value (NAV).

We offer the following suggestions for improvement:

1. We recommend defining subgroups of corporate exposures and identifying a set of drivers for each subgroup reflecting the market risk standardised approach.
2. We recommend having two measurement options, one being external ratings and the other being a slotting approach based on a bank's master rating scale (which may incorporate the proposed risk drivers), if ratings are not available. Any such use of risk drivers requires that they are calibrated to local and industry circumstances through an objective and transparent market indicator.
3. Banks that have approved processes for assessing internal ratings should be able to use internal ratings to determine risk-weights rather than public credit ratings. This would allow banks to leverage existing processes and infrastructure to apply a risk-sensitive approach.
4. If it is necessary to choose 2 risk drivers, leverage and debt service coverage (DSC) could be another alternative pair, although DSC may not always be a good indicator of the credit quality of the underlying borrower. All else being equal, revenue may further differentiate relative risk but is not necessarily conclusive and will unfairly penalize smaller borrowers if revenue effectively carries a 50% risk weight.
5. Other leverage measures such as Total Debt/Tangible Equity, Debt/EBITDA can also be considered. Other risk drivers that could reflect credit risk would be operating efficiency or liquidity ratios. Revenue and leverage alone we believe do not cover a company's ability to meet its obligations over the medium/long-term.
6. Generally, off-balance sheet leverage should be included in the calculation of leverage especially for larger entities and equity should exclude intangibles. This however will result in more complex calculation requirements that may not be readily available for most banks depending on the accounting practice of each jurisdiction. The requirement for inclusion where the obligor's auditors considers the exposures to be material also requires more clarification. Most material off-balance sheet items are required to be reflected in financial statements. Capturing this additional data requirement will be burdensome and provide little additional benefit to risk sensitivity. A materiality threshold for inclusion of off-balance sheet exposures is preferred.
7. Regarding the treatment of investment funds exposures, we propose a better and alternative approach based on the regulatory framework of investment funds, where:
 - a. Loans to investment and mutual funds, which are regulated by the highest standard in terms of investors' protection, should receive a RW of 50%
 - b. Loans to other regulated investment funds, such as alternative investment funds, should receive a RW of 75%
 - c. Loans to non-regulated investment funds should receive a RW of 100%.

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 objective of the proposed standard should be to keep financial institutions appropriately capitalised and not influence policy or lending decisions through favourable or unfavourable treatment of specific exposures. While it is impractical to identify and calibrate risk drivers that will be internationally applicable (particularly for SMEs), as a longer term exercise we support the continued investigation into risk drivers for SMEs and other exposures.

The proposed risk weights for corporates, as they apply to smaller firms, at first glance seem to be counter-intuitive with respect to the IRB corporate SME capital treatment. Specifically for a corporate and a corporate SME with the same PD, LGD and maturity, the SME size adjustment factor results in a more favorable capital treatment for the SME. In addition, SME portfolios are typically collateralised and collateral is not eligible under the mitigation rules – although we believe it should be. The floor of 60% for corporate is also too high for some high quality companies (e.g. high investment grade equivalent), which is not reasonably comparable with IRB measures.

A specific local calibration for the EU jurisdiction is represented by the SME Supporting factor in Article 501 of the Capital Requirement Regulations. It is important this existing approach should be allowed, both in the EU and worldwide, in the new Standardised Approach. Without it standardised approach banks providing lending support to small business, which are important drivers of jobs and growth, will be unduly penalised.

The so called SME Supporting factor is a measure that aims to immunise the quantitative capital requirement increase under Basel III for credit risk on exposures to SMEs. It has been introduced in EU Regulation as it is considered that SME portfolios are less risky than other corporates because of a lower asset correlation.

The regulation permits capital requirements for credit risk on exposures to SMEs to be multiplied by a factor of 0.7619. This should be allowed for all jurisdictions.

It is applicable to both Standardised and IRB banks, without additional operative/computational costs and is applicable to both corporate SME and Retail SME.

The proposed drivers of revenue and leverage are also not appropriate for Non-Bank Financial Institution (NBFI) type corporate exposure. NBFI corporate should be carved out with at least sub-categories of Funds, Insurance and Other. NAV and leverage could be used as risk drivers for funds, and a profitability ratio and leverage should be used for insurance. Based on the proposals, additional factors should be considered for SMEs so as to not penalise this segment since this could lead to unintended consequences such as restrictive lending which could also adversely affect the economy. Consideration should be given to developing a separate risk-weight table for SMEs.

Intuitively and demonstrably the risk of default for start-ups is higher than established companies so the rationale for allowing for a more lenient treatment does not appear to make sense. For start-up companies, though, whether 110% is unduly generous needs to be viewed on a relative basis. Based on the preliminary risk weights that range from 60% to 130% (taking aside the 300% risk weight), 110% would not be too lenient as the higher 120% and 130% risk weights are for obligors with very high leverage. Generally, there will be some conservative adjustment for start-up companies with no track record that would be applied by most banks in the credit and rating assessment process. Pro-forma financials could be considered for start-ups and the next higher level risk weight may be applied. This alternative however will not be simple to implement as an additional identifier for start-up companies will need to be captured. The additional cost of implementation may far outweigh the benefits of possibly a 10-20% risk weight difference for a very small population. So we believe the risk-weighting for start-ups should be 100% to maintain their risk-weighting as under the current framework.

We also find that the material jump from 90% -130% to 300% from very high leverage to negative equity is too steep. If the proposal proceeds, we expect that the risk weight levels will be reduced in the final calibration.

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

Introducing risk drivers, albeit in a limited number, becomes a quasi-IRB approach and increases complexity and consistency issues. While risk driver identification and calibration is a worthwhile objective, it is not practicable in the near term and will take years to develop, calibrate, and implement.

We believe, though, that risk sensitivity may be improved with little added complexity. External credit assessments reduce complexity and are more risk sensitive. A separate calibrated risk weight table for funds could also be used using the proposed leverage driver but replacing the revenue driver with fund Net Asset Value (a readily available data point). Industry, country and measures of delinquency may also be able to increase risk sensitivity with minimum complexity.

Specialised lending

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

The new category for the standardised approach increases the risk weights for specialised lending, such that they are significantly larger than the IRB measures. This would not appear to strengthen the link between standardised and IRB approaches.

There is also no empirical data to apply an additional risk weight floor for specialised lending categories and similar to the treatment of corporate exposures, this does not give benefit to the fact that specialised lending facilities are generally well secured.

The proposed treatment of specialised lending, in particular real estate secured lending, needs to be further revised and refined. In many specialised lending scenarios, counterparties similar to conventional corporate exposures simply do not exist. Also, for real estate secured lending, a risk driver-based approach incorporating several variables, such as DSC, LTV and Loan-to-Cost, is likely to be more effective if the risk drivers are carefully developed and calibrated to local and industry circumstances.

We also note the following:

- It is unclear as to who the “counterparty” being referred to is in order to assess whether the proposal improves risk sensitivity.
- The specialised lending category will enhance risk sensitivity but also increases complexity.
- Income producing real estate should have a separate treatment (possible drivers of project DSC and LTV).

The current standardised approach allows banks to switch between categories based on collateral. There is no sufficient recognition of this in the proposal and this should be restored.

Retail portfolio

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

There are several simple ways to increase risk sensitivity of the regulatory retail exposures treatment.

We recommend a differentiation between secured and unsecured exposures. We believe that the current 75% SA risk weight should continue to be applied for the rating of unsecured retail exposures. However, we believe that a materially lower risk weight should be applied for the secured part of any retail exposures based on the value of collateral at inception which should be objectively determined. In addition, there are some jurisdictions where DSC has more priority than LTV. Therefore, we believe that local treatments should be considered in accordance with lending practices and market characteristics.

For future consideration and in order to make the framework more risk sensitive, we also propose that the following secondary factors could be considered: delinquency, utilization, term, product type, and LTV. Empirical evidence confirms that all these drivers provide a meaningful differentiation of risk. These drivers should be available for most jurisdictions and at most financial institutions.

In addition to risk sensitivity, the proposed approach corrects the potential misalignment of incentives that could otherwise result from the increase of CCF for unconditionally cancellable exposures from 0% to 10% proposed by the Committee. This is illustrated below.

Consider a customer who only uses 10% of their available credit cards limit, and has not been delinquent in the past year on any credit card obligation. Empirical evidence shows that the probability of default for such a customer is significantly lower than for one using 100% of their credit limit and previously delinquent. Yet the first customer would have Standardised RWA equal $(10 + 90 \times 0.1) \times 0.75 / 10 = 142.5\%$ of their outstanding balance. By contrast, the second customer, who already uses 100% of their available credit cards limit, would have no undrawn limit and as such, Standardised RWA at only 75% of the outstanding balance.

Claims secured by real estate

- 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 agree that LTV has sufficient predictive power of loan loss, and a substantial (but not sufficient) predictive power of loan default.

By contrast, the DSC ratio would only have limited long-term predictive power at loan origination. Banks do not generally request borrower income information after granting credit. DSC has some predictive power of loan default, but its predictive power is less than for LTV or other risk drivers. This may be due to the fact that as part of prudent mortgage adjudication, the banks already verify that the customers have the means to re-pay their mortgage, independent of the performance of the property. Once this is confirmed, a lower or higher DSC ratio no longer provides significant risk differentiation among approved and funded mortgages.

We offer further comments below on the LTV and DSC ratios.

LTV comments:

- This is a predictive loss measure if the valuations are updated as market conditions change. The proposal to keep the value constant at origination will not achieve risk sensitivity.
- Predictive power of LTV varies across jurisdictions with varying legal and tax regimes. (e.g. US foreclosure laws vs. Canadian laws) and property price volatility histories. One grid for all jurisdictions does not recognise the country-specific risk profiles.
- LTV also becomes less relevant in jurisdictions with longer-term mortgages as re-financing is not an issue whilst collateral value still is. In Canada, mortgage terms are generally 5 years but other jurisdictions may have 20 year mortgages.
- Valuation standards as currently drafted (i.e. prudent valuation based on an independent valuation that does not need to be a 3rd party appraiser) provides flexibility but will be subject to inconsistent practices and valuation, which would not meet the comparability objective.
- Operational requirements such as an assessment of property values through the use of indexes, or “other loans with liens of equal or higher ranking than the bank’s lien” will be burdensome to implement. The proposed standard also introduces the burden of retaining information of other liens against the property that may not presently be available.
- LTV would need to be more defined than in the proposed standard.

DSC comments:

- Presently, there is no standard mechanism to estimate all financial obligations of a borrower.
- Definition applied to calculate the ratio will need to be standardised and jurisdictional differences again will need to be reconciled. Definitions and calculations will differ between financial institutions and across jurisdictions. Each bank will have its own established policies.
- Not updating the metric will not achieve risk sensitivity especially given term of these exposures may be long dated.

Detailed LTV and DSC information will also be challenging for portfolios presently subject to Standardised (non-AIRB).

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.)

Although we understand the practicality of using LTV and DSC based on values at the time of origination, both property values and consumer servicing capacity will vary significantly due to changing market conditions and borrower employment status, age, and other socio-economic factors. That being said it is much more impractical to use other indicators which may not be available at the borrower level, such as debt to income.

We also raise the following questions and concerns in relation to LTV and DSC:

- What are the requirements for independent valuation? Do they delineate model based valuations from physical appraisals?
- The Committee proposes calculating the LTV based on the total exposure on the property including undrawn commitments. Including undrawn commitments may reduce the risk-

sensitivity that the committee has attempted to introduce. Additionally, the standard should more clearly define when and how the appraisal value of the property can be adjusted from the value at origination. More clarity is also needed in the acceptable appraisal methods and whether estimations can be used. We further ask the Committee to consider using an indexed appraisal value rather than the value at origination, as it would more accurately reflect the credit risk of certain exposures. Using LTV or indexed LTV may be difficult to standardise across jurisdictions and financial institutions. Jurisdiction specific thresholds should therefore be considered.

- The Committee proposes using after-tax income in the calculation of the DSC ratio. Where calculated some jurisdictions may calculate the ratio based on gross (pre-tax) income. Net income would be difficult to estimate and apply consistently across financial institutions and jurisdictions. Payments can also be defined in many different ways (% of balance, actual payment, minimum payment etc.) making the use of this ratio impractical. Additionally, the use of the ratio as measured at origination does not seem to accomplish the goal of increasing the risk sensitivity of the approach since mortgage exposures can remain on book for many years after origination.
- It may be difficult to ensure all exposures secured by the same property are risk-weighted in the same way for instance where there are multiple mortgages or lines of credit.
- It will be difficult to ensure that adjustments to the calculation of DSC for variable rate loans are fair and consistent across jurisdictions.
- How would the mortgages that are renewed be treated? Would they be viewed as “newly originated” mortgages with new ratios?

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?

We do not believe that using a fixed threshold for DSC is appropriate. Different jurisdictions have very different tax regimes, social benefits, and structure of households' balance sheets. Moreover, the DSC calculation differs across jurisdictions and often across banks in the same jurisdiction. As a result, the same numerical value of the DSC ratio may correspond to very different levels of the customers' indebtedness across jurisdictions and across banks. This inability to come up with a consistent DSC ratio threshold further highlights the inappropriateness of using DSC as a risk driver across jurisdictions and banks.

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?

The risk sensitivity of residential real estate exposures could be increased by considering risk drivers such as delinquency, utilisation, term, product type, and a well-defined LTV. For instance for LTV we suggest the use of an internationally agreed global LTV metric that would be calibrated to local circumstances based on local housing market conditions. We recommend this process be done in an objective, fact-based, and transparent manner. We believe this would be different from national discretion as we suggest that the global metric and calibration process be subject to rules set by the BCBS and also subject to BCBS review similar to the RCAP.

Exposures secured by commercial real estate

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?

We believe that Option A is inappropriate and not based on actual experience when combined with appropriate risk management and controls. However, the exemption for well-developed and long established markets in footnote 59 for option A (par 44) seems meaningful to us. Thus we would prefer maintaining the status quo, so that a risk weight of 50 % could apply under strict circumstances as set out in footnote 59. Option B also has significant weaknesses. Under Option A, credit quality is the only consideration while under Option B, the focus is on the value of collateral in relation to the outstanding amount of the loan. We believe that it is important for both credit quality and collateral to be considered and there are no options that offer this possibility. There should be.

Option A focuses on counterparty default risk and assumes recovery on the real estate is similar to unsecured exposures. The treatment of commercial real estate as unsecured with a maximum risk weight of 300% would promote the reduction of lending to commercial borrowers or increase the interest rate on funds borrowed. As a suggested improvement, consideration should be given that based on an LTV threshold, the corresponding unsecured corporate risk weight would be reduced by a fixed %.

Option B focuses on expected recovery based on LTV. Given our earlier comments on LTV, this risk factor may also not be the best choice for risk weight measurement. In addition the floor of 75% risk weight under Option B is too high, and not reasonably comparable with IRB measures. The appropriateness will ultimately depend on the RW% levels. Under both options, the same issues on risk drivers noted in responses to other questions apply.

Based on the proposed definitions, i.e. primary source of repayment is not from income generated by the real estate collateral, the contemplated CRE would be mostly owner occupied real estate. The risk weights for exposures secured by commercial real estate are a very narrow range and there is also no consideration for the nature of the loan (e.g. real estate development, income producing real estate, owner occupied) or the quality of the collateral (e.g. land vs income producing, residential, retail, office, etc.). Rather than having to choose between two options, one of which is more along the "PD" dimension and the other "LGD", the final table should take both into consideration as this is aligned with banks' internal assessment of risk.

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

We suggest using some real estate market cycle indicator in individual countries/regions (the real estate market in different jurisdictions could be very different at the same point of time). Consideration should also be given to the nature of the loan and the quality of the underlying real estate. Please also refer to our responses to Q13 & Q14 above.

Currency mismatch risk weight add-on

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?

We agree that the add-on should be limited to retail exposures given the borrower is likely not hedging these exposures. However, consideration should be given to ensuring the add-on factor is lower for less volatile, more widely traded currencies.

Off balance sheet exposures

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

Given the categories and corresponding CCFs are pending further review and empirical support, the Committee should retain the existing CCFs until appropriate analysis can be carried out. Principally, the review should consider interdependencies between rule sets and impacts of increasing the CCFs across the Standardized Approach, the Leverage Ratio, scoring for global systemically important banks, Large Exposures Framework, and Banking Book Equity.

However, we support greater differentiation in categories that allows for better risk sensitivity if it would result in lower risk-weighting of certain off-balance sheet items. Additionally, retail categories LOC, Credit Card, and HELOC should be explicitly included as categories under the revised standardised approach, since the drawn down on retail exposures is difficult to compare with highly monitored commercial/corporate exposures. Commitments with future drawdowns subject to certain conditions to be met by the obligor should also be covered. We also find the proposal to increase the risk weighting from “20% and 50%” to “75%” in Table 1 to be very punitive. We would also like to understand the basis for using 10% for unconditionally or automatically cancellable commitments.

Commitment to which the CCF is applied should also be clarified. Is Commitment defined as:

- a) Bank issued commitment letter to customer, but customer has not accepted; or
- b) Bank issued commitment letter to customer and customer has accepted; or
- c) Bank issued commitment letter to customer and customer has accepted and loan is legally closed and available for drawdown.

We also seek clarification on the following items:

- For “unconditionally cancellable at any time by the bank without prior notice”, could this be further clarified as to whether a short notice period in a matter of days would qualify? We think it should.
- Revolving retail exposures (credit cards, lines of credit, overdrafts) are generally treated as “unconditionally cancellable” although some banks and some regulators might have other views. Since this distinction would have a huge impact on Standardised RWA (10% CCF vs 75% CCF), we recommend that the Committee gives clear guidance on how to treat revolving retail exposures.

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 agree in principle with the Committee’s proposal to review the CCF for unconditionally cancellable commitments for Retail exposures and Retail Mortgages (HELOC); however we note that certain types of credit facilities may be used differently under stress. We seek clarification on the proposed 10% CCF and the resulting capital charge for unused facilities as they may be disproportionate to the underlying risk.

We support the better alignment of the standardised approach treatment of unconditionally cancellable commitments for Retail exposures and Retail Mortgages (HELOC) with the Advanced IRB approach, where CCF is estimated based on the historically observed additional drawings prior to default, which are not all zero.

However in order to accurately reflect the true risk of these commitments, not only their CCF but also their risk weight under the standardised approach should be adjusted to better align with those under the Advanced IRB approach since lower additional drawings are observed with customers who have larger portion of credit limit unused. Otherwise, the risk weights for the revolving retail exposures (including both their drawn and undrawn portions) as a percentage of their outstanding balances would be misaligned with the actual risk of these exposures.

Thus the reluctance to recognise a much lower credit risk of the first customer in the Standardised risk weight could potentially create misaligned incentives for the banks, as well as the standardised outcomes contradicting the AIRB approach, which assigns a much lower risk weight to the first customer.

There are broadly two simple ways to remediate this misalignment.

1. In our responses to Q9 suggest simple ways to recognise lower Standardised risk weights for the retail customers who have a deeper relationship with the Bank, an established credit, or lower credit risk as evidenced by their lack of previous credit delinquencies and lower utilisation of available credit limit on revolving exposures. This will have an added benefit of assigning appropriately lower standardised risk weights not only to the drawn but also to the committed undrawn exposures to these customers (after the 10% Credit Conversion Factor proposed by the Committee). Therefore the overall Standardised RWA for revolving retail exposures, expressed as a percentage of their outstanding balances, will be directionally aligned with their relative riskiness based on the empirical evidence, and with their AIRB risk weights.
2. An even simpler way to remediate this misalignment would be to directly recognise a lower risk weight for revolving retail exposures (including HELOC), both the drawn and undrawn portions, where the utilisation of available credit limit (i.e. the drawn portion as a percentage of credit limit) is low. It is well known that a dormant credit card account, which has not had any outstanding balance for the last year, has an extremely low probability to draw a balance and default on that balance next year. Similarly, a credit card account with a zero or low utilization of the available credit limit has a very low probability of defaulting next year. By contrast, an account utilising more than 90% of its available credit limit has a higher probability of default. Assigning appropriately low standardised risk weights for low-utilisation accounts (including both the drawn and the undrawn portions after the 10% CCF) will accurately reflect their relative riskiness and will align with the Advanced IRB outcomes for these exposures.

Past due loans

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

We agree with the Committee that risk weights should reflect the level of provisions. An add-on which would vary based on a function of the amount of provisions would appear to be more risk-sensitive.

We suggest the risk weight for past due loans be based on the higher of a flat risk weight and a risk weight based on the sum of provisions and an add-on. A flat risk weight would ensure that there is a minimum capital level especially for cases where provisions may not have been assessed yet or may be insufficient. The latter component of the calculation recognises that banks have already established

provisions and add-on accounts for uncertainty in the provisioning. We believe that an add-on that varies with provisions is reasonable.

Exposures to multilateral development banks

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

We believe that the proposed risk weight treatment for MDBs is reasonable. We feel the MDBs should be considered a unique subset of corporates while retaining the current risk weights. For consistency, the regulations need to be clear that the 0% preferential treatment applies under the IRB framework.

Other assets

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

We need to understand what exposures would be classified as “Other Assets” or “Other Credit-Risk-weighted Assets”.

Using the 100% risk weight for all categories does not seem appropriate. The current Basel III framework which risk-weights other assets at 0% (cash & gold) and 20% (cheques) seems more appropriate. Moreover, we would reference footnote 32 of BCBS 2006 § 81 which states:

‘However, at national discretion, gold bullion held in own vaults or on an allocated basis to the extent backed by bullion liabilities can be treated as cash and therefore risk-weighted at 0%. In addition, cash items in the process of collection can be risk-weighted at 20%.’

We suggest that the classification of items as other assets be consistent with IFRS accounting rules. We believe that the Other Assets category should be similar to the current approach. There will need to be further clarification of the securitisation exposure rules because the new standardised guidelines do not come into force until 2018. Until then, would these exposures be subject to the proposed 100% risk weight?

We do believe that the proposed 100% risk weight for the residual “other assets” class is not appropriate for all types of other assets. The 100% risk weight appears to be a legacy of Basel I and we believe this should be revisited.

For example a 0% risk weight, could be applied to for cash in hand and equivalent cash items. In addition, gold bullion held in own vaults or on an allocated basis to the extent backed by bullion liabilities can be treated as cash and are therefore should be risk-weighted at 0%. In addition, cash items in the process of collection should be risk-weighted at 20%.

We also note that the Exposure draft on lease accounting is expected to bring all leased assets (i.e. rental properties) on the bank's balance sheet. Applying a 100% risk weight for such assets would be excessively punitive.

Eligible financial collateral

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

Even though reliance on external ratings may not be warranted, the alternatives suggested may not be feasible to implement for individual financial institutions.

Given the substantial volume of financial collateral, it will not be feasible to complete the necessary due diligence to assess the risk of default and if full/timely repayment is expected for each issuer of the financial collateral. The concept of "investment grade" appears reasonable but we believe that it would be difficult to implement operationally.

If agency ratings are replaced, any alternative approach will need to be aligned with the approach for determining risk weights for exposures to like issuers/counterparties in other portfolios.

Currently, shares of UCITS/mutual funds can be recognised as financial collateral. The current prudential treatment applied to shares of UCITS/mutual funds pledged for Credit Risk Mitigation (CRM) purposes under the Comprehensive Approach. However, for the purpose of the look-through approach, such collateral is considered eligible if the shares have a daily public price quote and if the UCITS/mutual funds are restricted to solely invest in other assets eligible under the CRM (§ 92 and § 104 of the Consultative Document).

We believe that the latter condition is too restrictive because it constitutes a binary approach, where UCITS/mutual funds holding a limited percentage of non-eligible assets have no value for the CRM. This treatment excludes from the CRM eligibility a broad range of UCITS/mutual funds, thus reducing the borrowing capacity of customers and the lending capacity of banks.

In order to introduce a more risk-sensitive framework, we recommend that banks be allowed to apply a partial look-through on the eligible assets held by the UCITS/mutual fund. As a safeguard to the recognition of this partial look-through, we also suggest limiting the percentage of non-eligible assets held by the UCITS to a maximum of 50% of the total portfolio.

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

We are significantly concerned with the risk-insensitive use of the supervisory haircuts in the "Comprehensive Approach" to calculating capital requirements for secured funding transactions (including repurchase agreements or "repos," reverse repurchase agreements or "reverse repos," securities borrowed and lent, and agency stock lending). The Comprehensive Approach mandates that banking organizations decrease the value of collateral received, and increase the value of securities posted, by pre-determined supervisory haircuts. These haircuts must also be applied for any foreign exchange differences, on both sides of the same transaction.

We see several flaws with this approach. The supervisory haircut percentages are generally higher than those actually applied in the funding of inventory today, particularly for equity funding trades. Furthermore, because the haircuts are applied without any netting, this approach is significantly misaligned with the risk of these transactions.

The lack of risk sensitivity is particularly acute for portfolios of trades. The approach assumes that for every counterparty and for every trade, each security posted as collateral increases in value, while each security received as collateral decreases in value at the same time. In addition, the approach

assumes that the impact of foreign exchange movements is always negative. The approach does not recognize the very real possibility that posted collateral and borrowed instruments might move in the same direction, rather than in opposite ones. This problem is compounded by the fact that this haircut approach would be applied with limited opportunity for netting, without netting, meaning that the larger the portfolio of trades with a single counterparty, the greater the overstatement of exposure.

The issues noted above are only compounded by the proposed increase in the supervisory haircuts for main index equities from 15% to 20% and for non-main index equities from 25% and 30%. We are concerned that this increase seems arbitrary and is not supported by any empirical evidence.

We therefore strongly urge the Basel Committee to actively consider various alternative non-internal model based alternatives for the measurement of exposures to securities financing transactions. This is consistent with comments made in the final large exposure framework and we urge the establishment of a dedicated work stream to carry this important initiative forward. The concerns that we have raised with regards to the Comprehensive Approach are similar to the issues that existed with the Current Exposure Method (CEM). Just as the Basel Committee introduced a revised methodology for exposures to OTC derivatives (the Standardized Approach to Counterparty Credit Risk (SACCR)), we ask the Basel Committee to do the same for secured funding transactions and introduce measures to ensure that appropriate netting, correlation and portfolio diversification benefits are captured.

Eligible credit protection providers

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

The key determinant for guarantor eligibility should be based on the absence of any economic relationship or interdependence between the borrower and guarantor and if there is true economic benefit expected from the guarantee. Thus, eligible guarantors should not be limited to non-corporates.

Could the BCBS also clarify what the “economic relationship” would be defined as when considering the relationship between the borrower and the corporate guarantor?

Additional comments

Credit derivative hedges without restructuring clauses

The Basel Committee proposes to give no credit risk mitigation benefit for credit derivatives without restructuring as a credit event. We believe this is overly penalizing since these credit derivatives do provide credit protection. We are concerned with the impact that this would have in the US and for cleared transactions. In the US, the standard ISDA credit derivative contracts do not include restructuring as a stated credit event. This is largely due to the structural nature of the US market, for which restructuring is a rare event. Furthermore, this proposal clashes with the larger macro-prudential efforts to clear more transactions. Cleared credit derivatives do not include restructuring as a stated credit event and so this proposal would incentivize banks not to clear credit derivative transactions.

Subordinated debt, equity and other capital instruments

Public and private equity holdings defined in paragraph 352 of Basel text are not for the purpose of capital gains and should not be risk-weighted at 300% or 400% which we assume is designed to

reflect price fluctuation risks. Some banks hold those instruments for the purpose of long-term growth and development of issuers and expanding comprehensive business relationship with them. So we believe such equity holdings should be positioned as financing equivalent to long-term loans where it can be shown that they are not being held for trading purposes. Where this is the case, we believe they should be risk-weighted as a corporate exposure and not to reflect fluctuation risks.

We propose that specific calculation method for those exposures should be as described below:

- They should be risk-weighted based on risk weight table for corporate exposures, with the risk weight doubled, reflecting the difference of LGDs between ordinary debt and equities. The LGD for equities is 90% and it is twice as high as that for ordinary debt, 45%, under Foundation IRB.
- Subordinated debt should be risk-weighted according to the creditworthiness of the corporate exposure, not at a flat 250%. The reason for applying 250% risk-weight to financial institution equities is to reduce the risk of double gearing between banks causing destabilisation of financial system. Therefore it would not make sense to apply the 250% to corporate equities.
- We propose that such investments will be risk-weighted based on risk weight table for corporate exposures with the risk weight multiplied by 1.67 times. The 1.67 takes into account the difference of 75% LGD for subordinated debt and 45% LGD for ordinary debt in Foundation IRB.