International Banking Federation

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Secretariat of the Basel Committee on Banking Supervision
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Dear Sir/Madam:

Re: IBFed[1] response to BCBS standardised approach for credit risk consultation

Introduction

The International Banking Federation (IBFed) is pleased to be able to provide its comments on the BCBS's consultative document, *Revisions to the Standardised Approach for credit risk*[2]. In addition, we appreciated the opportunity to participate in the industry outreach session on February 17th that was organised by the Task Force on Standardised Approaches (TFSA). We welcomed being able to share the industry's concerns with TFSA in more detail.

In general, we welcome the revisions to the original proposals that have addressed some of our concerns related to risk sensitivity. For example, we are pleased that the BCBS has decided to allow the use of external credit ratings for bank and corporate exposures in jurisdictions that allow for the use of such ratings for regulatory purposes.

Nevertheless, we have concerns over the risk-insensitive flat risk-weights that are proposed for certain exposure classes, such as regulatory retail exposures, unrated corporate exposures, and equity exposures, in addition to other exposure classes including land acquisition, development and construction exposures.

[1] The International Banking Federation (IBFed) is the representative body for a group of key national banking associations (please see our website for a list of current members at http://www.ibfed.org/members). Its main objective is to enhance the ability of banks to serve their customers in the provision of financial services.

[2] https://www.bis.org/bcbs/publ/d347.pdf

In this letter, we also provide our views on the due diligence requirement for bank and corporate exposures, national flexibility and risk weighting for residential and commercial real estate exposures, Credit Conversion Factors, currency mismatch, and the use of standardised approaches for a capital floor and implementation.

Risk sensitivity

In general, we are concerned that the proposed framework is too focussed on Probability of Default (PD) without reflecting Loss Given Default (LGD) or the type and quality of collateral. Furthermore, we believe that increased granularity is necessary for the risk weight buckets when moving between categories for the different exposures. We provide below our views on certain exposure classes.

Regulatory retail exposures

Given the BCBS's decision to re-introduce external credit ratings for bank and corporate exposures, we believe that risk sensitivity should also be enhanced for regulatory retail exposures, We are concerned that a flat risk weight of 75% has been maintained from the first consultation for all retail exposures, which for many banks represent a large percentage of their aggregate credit exposure. Specifically we suggest that a range of commonly recognised risk characteristics be established that identify lower-risk retail credit exposures. Examples of such criteria could include prime and super-prime (vs. near-prime and sub-prime) credit quality as identified in the Basel Securitisation Framework, revolving retail credit customers identified as transactors (vs. revolvers), customers with an established relationship with the bank, in particular with an established deposit relationship and collateralised retail exposures with LTV based on prudent criteria not exceeding 65%. Regulatory retail exposures satisfying any of these criteria would qualify for lower risk weights, as appropriate, where the national supervisor has comfort that there is sufficient loss history to support this lower risk weight. One key data point that could be used by national regulators to substantiate this lower risk weight is the default and loss history for the respective segment maintained by the banks within each jurisdiction that report RWA under the Advanced IRB Approach.

Corporate Exposures

For jurisdictions that allow the use of external ratings, we are concerned that greater risk sensitivity will not be achieved for the very large number of corporate exposures that are unrated, which may lead to level playing field issues. Such exposures would be assigned a risk weight of 100%, which may not be commensurate with the underlying risk and would not provide the risk sensitivity the Committee is seeking. This would be disadvantageous treatment given corporate exposures that are investment grade in jurisdictions that do not allow external ratings would be risk-weighted at 75%. For unrated corporates in jurisdictions that allow external ratings, we recommend adoption of the same investment grade/non-investment grade classification to allow for more risk sensitive measurement.

We are also concerned that exposures to low risk funds would be treated as unrated corporates under the proposed framework and be subject to the 100% risk weight. We recommend that regulated and low leverage funds be assigned a lower risk weight to improve risk sensitivity.

Similarly, the requirement under the Standardised Credit Risk Assessment Approach that the corporate "must have securities outstanding on a recognised securities exchange" is unreasonable as there are a large number of corporate entities that will not have such securities but are nevertheless considered investment grade. Examples include sovereign wealth funds, pension funds, and many asset managers.

Bank Exposures

There should be greater differentiation in risk weights under the External Credit Risk Assessment Approach (ECRA) for banks. We believe that there should be differentiation in the base risk weights between A+ to A- and BBB+ to BBB- banks. Currently the risk weights for both buckets are 50% and we recommend changing the risk weight for banks rated A+ to A- to 35% to reflect the lower risk of more highly rated investment grade banks.

For the Standardised Credit Risk Assessment Approach (SCRA), we request greater clarity on the criteria for and the differences between the Grade A, Grade B, and Grade C buckets. We are also concerned that the basis of the categorization between Grade A, Grade B, and Grade C is operationally burdensome and may not provide the true risk sensitivity desired. The requirement that a counterparty Grade A bank would need to surpass <u>all</u> regulatory minimums and buffers as implemented by its national supervisor would pose significant operational challenges. In particular, we would like to see clarification on whether this requirement would apply to all of the bank's subsidiaries as complete data may not be readily available, depending on the jurisdiction.

In addition, the proposal does give some relief through lower risk weights for short-term interbank exposures. "Short-term" is defined here as being 3 months original maturity or shorter. This definition of short-term is inconsistent with other rulemakings, such as the Net Stable Funding Ratio, Total Loss Absorbing Capital, and even the accounting frameworks, which all use 1 year as the definition of short-term. Similarly under the Internal Ratings Based (IRB) methodology the maturity is typically floored at 1 year. We therefore urge the Basel Committee to revise the definition of short-term to 1 year to better align it with other macro-prudential rulemakings and promote consistency, which will avoid *inter alia* banks being required to track a number of different expressions of what is short-term, leading to costlier operationalisation.

Specialised Lending

We are concerned about the punitive risk-weighting treatment assigned to the separate asset class of specialised lending activities (i.e. project finance, object finance, commodities finance) when an issue-specific external rating is not available or not allowed. We believe a flat risk weight of 120% is overly punitive for what is considered a secured loan in the case of object and commodity finance activities. In the case of project financing, the proposed risk weight of 150% in the pre-operational stage and 100% in the operational stage appears excessive. Banks' due diligence processes would ensure that the project being financed would be able to generate sufficient funds to repay the loan provided. As such, we do not believe a higher risk weight than 100% is required for the specialised lending category given the requirement that sufficient due diligence be undertaken.

Off-balance sheet exposures

The requirement that a Credit Conversion Factor (CCF) must be greater than 0% regardless of the exposure type is overly conservative and is not consistent with the IRB approach. We also believe this does not achieve the goal of correctly quantifying the risk associated with the lending product.

For retail unconditionally cancellable commitments (UCC), the increase in CCF from 10% to 20% contemplated in the second draft of the BCBS's proposal does not reflect the significantly lower underlying default risk and unduly provides increased risk weighting on those individuals who utilise little or none of their credit limit. The majority of unused retail credit limits are in dormant accounts and/or belong to the best credit quality customers. In either case, they have an extremely low probability of default, which is reflected industry wide in their AIRB PD estimates and therefore risk weights. Applying a flat risk weight of 75%, which is an order of magnitude higher than their risk weights under the AIRB approach, coupled with a 20% CCF, would unduly penalise these low-risk revolving retail exposures. The contemplated risk weighting is also at odds with the nature of the current regulations around consumer credit protection. Applying such a rule across the board would ultimately only change the way retail commitment contracts are written and activated, and reduce credit limits available to the best credit quality retail customers, and in particular transactors (such as travel credit cards' limits), and/or increase banking fees.

We also believe that the range of 50 – 75% for non-retail UCC is overly conservative as it does not reflect the actual usage ratios of these credit lines and would adversely affect lending and economic growth. Furthermore, the introduction of this approach would mean that there is little to no difference in capital requirements between the cancellable and non-cancellable commitments and the banks will receive very little capital relief from making a commitment cancellable. We would argue that there are good reasons why a commitment is judged to be unconditionally cancellable as it puts the bank in a better position to manage its risks, which should be recognised in reduced capital requirements.

For product types that truly allow the bank to cancel uncommitted facilities at any time in practice, we believe that it is reasonable to apply the lower CCF proposed for Retail UCC to non-Retail exposures where there are demonstrated controls and legal rights, monitored with robust internal bank governance processes. Additionally, a lower CCF should be considered for ADC facilities that are subject to stringent conditions precedent, such as level of presales or construction completion that are phased in over a longer term horizon.

We believe supervisors should be allowed the flexibility to determine whether unconditionally cancellable facilities are truly cancellable in their jurisdictions and then be allowed to prescribe a risk weight.

We understand that the Committee is conducting further analysis on the appropriate definition and calibration and would appreciate if the Committee can share, for industry's review and further input, the data and studies referenced in support of higher CCFs. We believe that it is possible to implement well defined criteria for non-retail UCC to better differentiate facilities that rightfully should qualify for lower CCFs commensurate with the risks, and we look forward to assisting in their design.

Due diligence requirement for bank and corporate exposures

We agree that banks should perform independent internal due diligence analysis and not solely rely on agency ratings for credit decision-making purposes.

We are concerned that the due diligence analysis will vary across jurisdictions. A formal recognition of rating agencies could be undertaken by the national supervisor with the supervisor publicly disclosing the criteria that these agencies met in order to qualify, and in such cases adjustment to the base risk weights would not be required. For example, ESMA provides a list of eligible external rating agencies in the European Union[3].

Alternatively, in jurisdictions where this is not the regulator's preference, due diligence could be performed by the banks as a group for each of the major external credit assessment institutions (ECAI) so that a similar level of rigor is applied across jurisdictions, and ratings issued by these eligible ECAIs could be used in the same manner by all banks to ensure comparability. We further suggest that both increases and decreases of the base risk weights for bank and corporate exposures be permitted as a result of the due diligence analysis, and not just increases as suggested in the consultative document. It is also important to note that credit rating agencies publish updates to their ratings at certain intervals. New information may arise that suggests a more favourable rating, for example, than what has been published and, as such, should be allowed to be reflected in regulatory capital calculations.

Residential and commercial real estate exposures

The approach to risk-weighting of real estate exposures, which form a significant proportion of banks' balance sheets, is of key concern to us. Further deliberation on the Committee's proposals in this respect is required as the provision of housing finance during its

[3] https://www.esma.europa.eu/supervision/credit-rating-agencies/risk

construction phase or once completed is one of the vital services that banks provide to their customers.

We generally agree with the use of the Loan-To-Value (LTV) ratio as an important metric for differentiating between risk weights for real estate exposures although recognise that some jurisdictions require banks to take into account a borrower's ability to pay, both for ‘treating customers fairly’ and prudential reasons. Where this applies, national competent authorities should be able to take such metrics into account. We also welcome the use of operational requirements in the Real Estate exposure class. However, we believe that certain exposures such as residential real estate may have notably different risk characteristics across jurisdictions due to local default experience or jurisdictional specificities, and that it would be appropriate to allow national regulators to set potentially different risk weight requirements, which can be lower than the prescribed base risk weights.

In addition, we have concerns with the difference in the proposed risk weight treatment between income-producing real estate (IPRE) exposures, where repayment is materially dependent on the cash flows generated by the property, and non-IPRE exposures. We believe that it would also be clearer from an implementation perspective if a materiality threshold were specified to ensure greater consistency, comparability, and applicability on both a national and international basis. Further clarity should be provided in the document in defining when exposures move from the classification of ADC to IPRE.

We find that the divergence in risk weights between IPRE and non-IPRE is too great for both residential and commercial exposures. For residential exposures, where operational requirements are met, the risk weights range from 70% to 120% for IPRE but only 25% to 55% for non-IPRE. We also believe that risk weights for IPRE exposures are too high in absolute terms. When making IPRE loans banks assess both the borrower’s capacity to repay in underwriting, and take a conservative view of property-related income in servicing calculations and therefore the proposed risk weights appear very punitive. We also note that unsecured retail exposures are risk-weighted at 75%; however, secured loans for IPRE with an LTV of 80% are risk-weighted at 90%, an obvious discontinuity. We would request that the Committee revisit the IPRE risk-weighting based on the QIS results, and provide the banking industry with transparency by making accessible any data and studies behind the proposed risk weights.

We are also concerned that smaller banks will be significantly impacted compared to larger banks by increasing risk weights on IPRE as they often have a higher proportion of these types of mortgages on their books. We believe that the proposed changes would hurt the rental market in many countries where they provide a significant proportion of housing supply and will make affordable housing less available. Finally, we are also concerned that we may not be able to identify whether a property is IPRE or non-IPRE over the life of the mortgage as the property may be rented out without notification to the bank. The requirement to consistently monitor for a change in status would be difficult to operationalise and would represent a change in market practice and reflects the changing nature of short-term renting brought about by innovators such as Airbnb.

Land acquisition, development and construction (ADC) exposures

We believe that a flat 150% risk weight for ADC exposures is very punitive and disregards the spectrum of risk profiles that exist with ADC exposures, and that the risk weight treatment should reflect the level of risk that the bank is willing to take. Moreover, the flat risk weight could promote more risk taking by all banks that operate in this space to seek higher yields by taking on more risk, as safer ADC exposures will not attract the same level of yield, but will require the same level of capital.

Instead, the risk weight treatment for ADC exposures should take into account key underwriting attributes to measure the level of risk that the bank is taking and the risk weight of the ADC exposures should be adjusted accordingly.

We suggest a bifurcation of the category to include a new category, residential real estate under construction, which would carry a lower risk weighting perhaps based on a slotting approach that would take into account the LTV ratio, sponsor support and financial strength, market, land marketability, and collateral presales and preleasing, deposits, length of the construction build, and property type.

We note that the FDIC in the US has issued helpful 'FAQs' on this topic in relation to the scope of 150% risk weighting of HVCRE loans[4].

Subordinated Debt, Equity and Other Capital Instruments

We believe that applying a 250% risk weight for equity holdings that are not deducted is excessively conservative, particularly compared with a 100% (unrated) risk weight for corporate exposures and a 150% risk weight for subordinated debt. We consider that an add-on to the risk weight assigned to the senior exposure would be a sensible and risk sensitive approach (similar to the use of a 90% instead of 45% loss given default (LGD) under the FIRB) for equities. We believe that a flat risk weight set at the current proposed level is too punitive and does not truly reflect the actual risk. If more risk sensitivity can be achieved in a simple manner, this should be pursued.

Alternatively, we would consider a risk weight in the range of 200% appropriate for equities, (which is two times the proposed risk weight for unrated corporate exposures) reflecting a difference in the LGD under the foundation IRB (FIRB) approach (i.e. 45% for senior debt and 90% for equity).

[4] https://fdic.gov/regulations/capital/capital/faq-hvcre.html

Because equity in the banking book may be currently held for the purpose of maintaining a long-term relationship between a bank and its corporate customers, we believe a sufficient transitional period or grandfathering provisions (for example, at least five years) should be included upon implementation, if a risk weight for equity would significantly increase compared to the currently applied risk weight of 100%. In addition, sales of such equity holding may require a delicate negotiation with the corporate customer who may have to revise its capital policy and/or find an alternative long-term shareholder.

Capital floor based on standardised approaches

The establishment of a floor for IRB banks based on the Standardised Approach capital requirements is something that we continue to disagree with. While we acknowledge that the existing IRB floor, based on Basel I, needs to be replaced as the framework is substantially different from Basel III, we believe that simply imposing a floor based on the Standardised Approach, which is in itself inferior in risk sensitivity compared to the IRB approaches, will not accomplish the Committee's stated objectives. We look forward to the opportunity to review and comment on any future proposals on a capital floor framework.

Currency mismatch

We believe requiring a currency mismatch add-on for corporates is not appropriate. Such risk is already incorporated in the external rating and is supported by the bank's own credit assessment and due diligence. Creating an add-on will create operational issues around the processes for assessing whether or not a natural or legal hedge exists, the costs of which will, in our view, outweigh the benefits.

Implementation

As noted in the consultative document, we appreciate that the Committee "will provide sufficient time for implementation taking into account the range of other reforms that have been, or are due to be, agreed by the Committee". We would stress that implementation timing should not be accelerated as proper calibration of the standardised approach is needed by means of QISs, and the banks will also need time to operationalise the new requirements.
We would also stress that QISs and proper calibration are very important because of the interaction with capital floors, and the leverage ratio, for example.

Conclusion

In conclusion, we welcome the helpful changes that the Basel Committee has already made to its original proposals for revising the standardised approach to credit risk. However, we believe that further refinement is required to meet the Committee's objectives of providing a more risk sensitive standardised approach whilst not increasing the overall level of capital standardised banks hold against their credit exposures.

We thank you for taking our comments into consideration, and we look forward to future discussions on this important issue.

Yours sincerely,

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