March 24, 2015

Via Electronic Submission
Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland

Re: Consultative Document: Revisions to the Standardized Approach for Credit Risk

Ladies and Gentlemen,

We appreciate the opportunity to comment on the Consultative Document for the Revisions to the Standardized Approach for Credit Risk issued by the Basel Committee on Banking Supervision. We support the Committee's proposed revisions to the current standardized approach for credit risk as part of its overall aim to strengthen the existing regulatory capital standards and review the standardized approaches for Market Risk and Operational Risk.

We believe it is important to improve the existing risk framework in order to increase its overall risk sensitivity through reduced reliance on external credit ratings, limited national discretion requirements and stronger comparability between the standardized and internal ratings-based approach, thereby ensuring the proper reflection of the risk profile of each asset on the Banks' balance sheets.

Our comments below are aimed at addressing some of the questions and considerations raised in various sections across the consultative paper while providing the Committee with insight on the impact of these proposals on the capital requirements of our institution, taking into consideration some particularities related to the domestic market in which we are operating which shares many characteristics with other markets in the region.

We hope the Committee finds these recommendations helpful in accomplishing their objectives and we remain at your disposal for any additional information and clarification regarding the contents of this letter.

Respectfully yours,

Market, FI & Country Risk Management Team *
Group Credit Libanais S.A.L., Beirut, Lebanon
** The opinions and views expressed in the comments below do not reflect that of Group Credit Libanais S.A.L., the domestic banking sector, any market participants or the national regulators, rather, they are solely the opinions of the Market, FI & Country Risk Analysts who reviewed and contributed, for commentary purposes and for the aim of fostering cooperation on the matter, the consultative document issued by the Basel Committee.*

Exposure to Banks

1. **<u>Common Equity Tier 1 Ratio:</u>**

The choice of the Common Equity Tier 1 Ratio is suitable in various aspects considering that it entails the highest and best level of quality of capital having the most robust loss absorbing capabilities. This level of capital will help indicate the Bank's ability in maintaining the going-concern and viability of its activities noting that the calculations of the Common Equity Tier 1 should be in accordance with the Basel III requirements which details specific and prudential characteristics for the inclusion of capital instruments in the aforementioned level of equity.

However, the use of the Bank's Risk Weighted Assets raises a number of concerns which include mainly the following:

- In the case of Banks using the standardized approach, the computation of the RWAs will be based on the current methodology largely reliant on the Credit Ratings of external credit assessment institutions to assign risk weights to exposures with Banks and Corporates, noting that one of the main aims of the proposed revisions is to improve the risk sensitivity of the standardized approach by reducing the use of external credit assessments;
- How will the Committee manage to implement the revised approach when one of the metrics used to assign a risk weight, i.e. the computation of RWAs, is still based on the currently adopted approach?;
- Will the Committee adopt a transition period whereby the first Solvency exercise under the new adopted approach will be based on the CET1 Ratio computed as per the current approach, after which the revised approach can be smoothly followed?

In an effort to maintain the simplicity of the process and stress on the importance and significance of the Common Equity Tier 1 Capital as the highest quality of capital and an indicator of the Bank's overall solvency, we suggest that a non-risk-based ratio would be more relevant, possibly using the Leverage Ratio (CET1 / Total Assets and Off-Balance Sheet Assets) or a ratio measuring the CET1 over the Bank's aggregate assets.

2. **<u>Non-Performing Assets:</u>**

The NPA ratio is considered an effective measure of the quality of the Bank's assets as it takes into consideration its overall Banking Book exposures noting that the ratio ranges applied in the risk weighing table are appropriate for the NPA ratio. However, using the Bank's Non-performing Loans ratio could prove to be more simple and straightforward given that most Banks already disclose their NPL ratio and are not required to compute it specifically for this exercise, or stress on the disclosure of the NPA as part of any Bank's regular disclosures packages.

In the breakdown of the components used for the computation of the NPA ratio, the revised standard mentions that the ratio is to be calculated after the deduction of provisions attributable to assets in that ratio and have therefore reduced the common equity, which raises the following concerns:

- Should the provisions taken into consideration be solely comprised of specific provisions or are collective provisions required to be included in the ratio given that the former is attributable to specific non-performing assets (in the numerator) and the latter is attributable to the overall lending/investment portfolio (in the denominator); and
- With regards to provisions which have reduced common equity, is the Committee referring to Credit Loss expenses intended to increase the Bank's provisioning levels which are deducted from Net Profits included as part of the Common Equity capital?

3. Disclosure Requirements

With regards to the disclosure of both ratios, the majority of domestic or regional Banks, particularly in emerging countries, either do not publish the required detailed information related to their capital adequacy and asset quality or are not disclosing said information on the frequency required by the Committee. Given that any exposure to Banks which are not disclosing these information will receive an elevated risk weight of 300% as mentioned in the consultative document, the Bank will have to be selective with regards to the correspondent Banks it deals with in order to avoid any significant increases in its capital requirements.

We suggest taking into consideration the fact that a number of Banks, particularly those in emerging countries, will not be able to abide by the disclosure requirements, thereby possibly reconsidering the elevated risk weight of 300%.

4. Short-Term Claims

The revised approach sets a preferential treatment for Short-term claims on Banks reducing the assigned Risk Weight as per the risk weighing table by 20 percentage points subject to a floor of 30%. Noting that the aforementioned treatment raises the floor of risk weights for Short-term claims by 10 percentage points, what was the reason behind the Committee's decision for said rise especially given that it only concerned claims with a maturity less than 3 months with investment grade Banks?

As per paragraph 64 of the Basel II Document, any short-term claim on domestic Banks in domestic currency can be assigned a preferential treatment on category less favorable than that assigned to sovereigns, subject to 20% floor if the country of incorporation of that Bank has applied a preferential for claims on the domestic sovereign in domestic currency as detailed in paragraph 54 of the same document.
The revised approach does not provide any information with regards to the aforementioned claims.

5. Impact on Banking Book Capital Charge

In general, the impact on the Banks' Banking Book exposures to Banks and Financial Institutions, with the exception of Subordinated Debt and Capital Instruments, is negative as the minimum risk weight applied to the highly rated financial institutions is 30% up from 20% raising the aggregate RWAs and corresponding capital requirements.

Claims on Banks in our local jurisdiction, especially long term exposures such as Bonds and Certificate of Deposits, witnessed a drop in their capital requirements as their risk weight is no longer capped by that assigned to their sovereign of incorporation but rather on their own capital adequacy and asset quality metrics, both of which have proved to be robust in the banking sector.

In fact, exposures to local Banks have been assigned more favorable risk weights than that assigned to some International Banks. The aforementioned treatment is somewhat questionable given the Committee's aim to improve the risk sensitivity of the standardized approach yet is assigning a lower risk weight to a Bank incorporated in a country rated below investment grade than an internationally functional Bank incorporated in A+ to AAA rated countries. In other words, the operating environment factor should be taken into consideration.

Exposure to Corporates

1. **Revenue**

As already mentioned in the consultative paper issued by the Committee, the use of absolute values for the Revenues metric of the Corporate entity can prove to be somewhat ineffective when the country in which that counterparty is operating is not taken into consideration. For example, in the case of a country with a relatively low GDP, a large portion of Banks' Corporate Portfolio would automatically be categorized in the section of Revenues below EUR 5 million; thereby qualifying these exposures to a 100% risk weight at least. Given that the majority of Corporates operating in the same country are most probably unrated and are currently assigned a 100% risk weight under the standardized approach, this would not improve the risk sensitivity of the standardized approach in relation to its Corporate lending portfolio.
Therefore, we would suggest replacing the Revenues metric by a ratio related to the counterparty's overall turnover, such as Revenues/Assets, Revenues/Equity thereby taking into consideration the size of the Corporate counterparty or the Gross Profit Margin which would indicate the counterparty's earnings strength while incorporating its Cost of Goods sold and avoiding the possible cyclicality of its profitability.

2. **Leverage Ratio**

While the Leverage ratio would be considered a good indicator of the counterparty's indebtedness, overall levels of leverage differs from one sector to another thereby putting highly leveraged Corporates at a risk weighing disadvantage noting that said counterparties could be reporting relatively adequate levels of debt in terms of their respective sectors.
Moreover, we suggest replacing the Leverage ratio by another indicator of the counterparty's ability to service its debt, thereby eliminating any bias to highly leveraged sectors and maintaining a clear representation of its indebtedness profile such as:

EBITDA-To-Interest Coverage Ratio: $$\frac{\textbf{EBITDA – CAPEX}}{\textbf{Interest Expenses}}$$

Whereby:

- EBITDA is the Earnings before Interest, Taxes, Depreciation and Amortization
- CAPEX is the aggregate amount of Capital Expenditures

Finally, we suggest not taking into consideration the guarantees extended by Corporates in the Leverage ratio to avoid increasing the complexity of the revised standardized approach, given that only guarantees having specific characteristics and features should be considered eligible, and in order to maintain a more conservative approach in the risk drivers.

3. **Small and Medium sized Entities**

One of the main issues raised by the Committee is the potential cliff effects for exposures to small and medium sized entities which would not qualify as part of the retail portfolio and are therefore treated as low revenue corporates.
Given that these entities are considered as in a transition phase, we suggest applying a similar treatment to that applied to start-up companies assigning a more lenient risk weight for a particular time frame to allow the counterparty to finalize its transition from the retail to the Corporate portfolio. After that window of time, the counterparty will have either become a relatively average revenue Corporate entity due to its growing activities or would still be a low-revenue Corporate entity due to its lagging activities thereby justifying a higher risk weight.
In addition, special consideration should be taken with regards to the Financial Statements of SMEs where most SMEs are not required to disclose any financial statements making the process of collecting the abovementioned ratios somewhat challenging.

Subordinated Debt and Equity

The proposed changes in the revised standardized approach would be considerably unfavorable for any Bank holding such instruments noting that the assigned risk weight has more than doubled compared to the current approach. Moreover, in emerging and less developed markets, the impact of these changes will be even more sizeable given that a major portion of Subordinated debt and equity instruments issued by Banks or Corporate entities operating in these markets, are not listed thereby entailing a 400% risk weight. This treatment would discourage Banks from investing in these instruments, thereby constraining an already less active market.

Given that the Committee has stated that raising Banks' overall capital requirements is not one of the objectives of the revised standardized approach, we suggest revising the suggested risk weights for Subordinated debt and equity exposures.

Claims secured by Residential Real Estate

1. **Debt Service Coverage Ratio**

While the use of the Debt Service Coverage ratio is appropriate indicators to improve the risk sensitivity of the revised approach, the proposed methodology of that ratio is not optimal.
Given that the DSC will be measured only once at origination, i.e. the borrower's income information will only be measured at the origination of the loan to assess their ability to service their loan, the effectiveness of that ratio will be compromised. The borrower might experience several positive or negative changes in their work life which would alter their ability to service their debts such as experiencing a sizeable raise or losing their employment in tough operating conditions. Given that we agree that obtaining income information can be challenging, we suggest omitting the DSC ratio as a risk driver to determine the appropriate risk weight of the exposure and improve the risk sensitivity of the approach by assigning different risk weights according to the exposure's LTV ratio.

2. **Loan to Value Ratio**

With regards to the LTV and while it is impacted by the same issue as the DSC ratio in terms of setting the value of the property once at the origination of the loan, we believe that real estate prices have proven to be somewhat stable in normal economic conditions.
However, we suggest providing discretion to the national regulator to set the appropriate ranges to assign a corresponding risk weight taking into consideration specific domestic rules and regulations with regards to residential real estate lending.

Claims secured by Commercial Real Estate

Given that the nature of the loan secured by Commercial Real Estate is considered to be relatively different from any other unsecured exposure to Corporate or retail counterparties, we believe that Option B should be adopted, assigning the risk weight according to the value of the collateral in the exposure.
However, we suggest providing discretion to the national regulator to set the appropriate ranges to assign a corresponding risk weight taking into consideration specific domestic rules and regulations with regards to commercial real estate lending.

General Comments

The revised standardized approach entails more complex treatments to determine Banks' capital requirements, requiring the collection of several ratios with specific computation methodologies, compared to somewhat straightforward readily available information under the current approach. Will the Committee assist Banks with the collection of information and overall computation of its solvency by providing a specified model designed to meet all the needs of Banks to complete the process?

The current revised proposals for the standardized approach does not include in any form the qualitative aspect of assessing a counterparty's risk profile, only concentrating on clear and defined quantitative ratios to measure Banks' capital requirements. This omission somewhat weakens the Committee's efforts to improve the overall risk sensitivity of the standardized approach.

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