



POLISH BANK ASSOCIATION

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Basel Committee

on Banking Supervision

Dear Sirs

Subject: Second consultative document on revisions to the Standardised Approach for credit risk

Polish Bank Association welcomes the opportunity to comment the second consultative document on revisions to the Standardized Approach for credit risk. In my opinion the second document is better calibrated to the real level of risk generated by each category of credit portfolio than the previous version. However, the project has still some shortcomings which Polish Bank Association would like to indicate below in detailed comments.

It is also necessary to underline that the present status of proposal does not allow to evaluate fully the scale of consequences generated by adoption of new standard. The main reason is the lack of prepared drafts of other Basel Committee prudential regulations, particularly, the lack of proposed risk weight approach in area of sovereign. This shortage is visible and important for banks because the projected regulations concerning credit risk are in some places connected directly with future prudential requirements in other areas. In my opinion the complete review of interaction with other regulatory reform initiatives, not only proposed by the Basel Committee, is necessary before the

adoption of final regulation. In other situation the tsunami of regulations may lead to unexpected consequences for stability of financial institutions and for lending economy.

Recommending new standards the Basel Committee should also have in mind the necessary following step, which is the implementation of standards to local jurisdiction. In Europe there is general approach to broaden the scope of institutions which have fully apply the Basel Committee regulations. In fact these regulations are binding requirements for nearly all credit institutions active on European market, not only for the biggest international banks. This approach makes the fundamental challenge to construct the system of risk weights which will be adequate for all categories of banks, including the smaller ones. That is the principal reason why I would like to emphasize the problem of necessary simplicity in prudential regulations.

I would like to express my hope that the coming QIS conducted by the Basel Committee will be helpful tool which allows to calibrate properly the final new requirements. Doing this work the Basel Committee should also have in mind that many other prudential regulations for banks were adopted in last years and we can expect the next ones in near future. All together they create the regulatory environment for development of banking activity. In my opinion new standard should minimize the potential negative impact of new regulations on financing real economy by banks. This threat is real because the new proposal will generate higher capital requirements for banks in comparison to the actual requirements.

I would like also to inform you that the standardized approach for credit risk is of big importance for Polish banks. The overwhelming majority of banks active on this market applies this standard directly and only the minority may treat it as the floor for assessment made under IRB method.

The following detailed comments prepared in Polish Bank Association are divided into each category of exposures presented in the second consultative document.

Bank exposures

Consistent with aim of the Basel Committee to reduce the mechanistic reliance of prudential regulation on external ratings, the secondary proposal introduces the concept of due diligence requirement for banks in order to assess in proper way the creditworthiness of bank's counterparties. This solution is to ensure that banks will undertake their own assessment of risk level and establish adequate capital buffer. Accepting this general approach for banks applying the

external rating in area of bank exposures, I would like to indicate some shortcomings of actual proposal.

The new due diligence requirement was pictured in very general way and this approach may generate some principal problems for banking sector. Firstly, it is necessary to remind that banks have the procedures to assess the quality of bank exposures. In this context it would be good to know if new prudential requirement should be bound in any way with the procedures existing in banks. The credit institutions are not sure if the actual practices used by them will have to be substituted by new ones or it will be allowed to apply the actual procedures in consistent way with new requirements. If the second approach is correct, the additional question concerns the way of approval for application the existing method in banks in the future. This matter should be clarified in final version of new standard.

Secondly, if new strict due diligence requirement is to be adopted by banks, more details should be delivered in regulatory proposal. I am afraid the maintaining of general requirement only may generate unlevel playing field in the banking sector. If each bank is allowed to prepare its own due diligence process of verification of bank exposures, the big differences in practical application may appear. This freedom may lead to principal difference in prudential risk weights applied by each bank. In consequence the similar bank exposure can have different price for each credit institution.

Thirdly, the use of external rating will be allowed by banks if the jurisdiction permits do it. The proposal does not deliver the detailed information in which form the allowance will be granted and under which conditions. The lack of details in this area may generate the unlevel playing field in international scale if some jurisdictions decide to approve the external credit risk assessment approach and others decide not to do it.

The standardized credit risk assessment approach is to be used for unrated bank exposures. This method generates also some concerns in banking society. The proposal delivers the criteria and triggers for assigning bank exposures to different SCRA grades. However, the general criteria and triggers leave quite broad room for interpretation which allow banks to assign the similar exposures to different SCRA grades.

Another point that we would like to bring up is the minimum risk weight of 150% if any of the published and binding minimum regulatory requirements determined by its national supervisor is breached. We appreciate footnote 35 making clear, that liquidity requirements in this context are not considered "binding". However, the minimum risk weight of 150% may exclude the bank in recovery process from the interbank market.

I would like to declare my support for preferential treatment of short-term bank exposures as it was included in the second consultative document. However, the regulator should avoid the risk to generate potential cliff effect in regulation. The substantial difference in the level of risk weights applied to short- and long-term exposures may generate the unfair regulatory preference for short-term exposures. This consequence should not be the priority of regulator when banks prefer usually the short-term interbank exposures. In order to minimize the potential impact of cliff effect it is also worth to consider once again if the residual period is not better indicator of real exposure risk than the original maturity period.

Given that the risk profile of covered bonds is quite different from the risk profile of the issuing bank, separate risk weights should be assigned to covered bonds, reflecting the historically low level of losses in the covered bond market. It is to be acknowledged that covered bonds are governed by specific legislation that fulfils a number of strictly defined criteria.

Finally, the grades of risk weights for bank exposures should be set up in special way in the existing bank networks. If the banks collaborate in one network, approved by the supervisor, fulfilling all prudential requirements in order to be treated together as the institutional protection scheme (IPS), they should have the strong preferential treatment of their mutual exposures. The part of these exposures is mandatory requirement for all participants in order to make the network safer, as for example the mandatory deposits maintained by banks in central institutions. In my opinion the participants of IPS cannot be penalized for cooperation which should limit the risk generated by whole network. This problem is especially important for network of cooperative banks acting in one jurisdiction. There is the need for allowing local authorities to adjust the framework to address such unique business models. I want also to add that this model is necessary for balanced development of banking sector and better financing the economy.

Corporate exposures

The corporate exposure classes include a wide variety of counterparties and products. The principal division may be made into the counterparties which have the external rating and the clients without it. My comments must be also follow this class division.

In area of corporate clients with external rating I have to repeat my general comment concerning additional requirement for banks to perform due diligence assessment of exposure as I have done it in area of bank exposures. The rules of due diligence performance are too general and they may create regulatory conditions for unlevel playing field in banking sector. This danger should be

recognized as relatively high being the consequence of undesired problems in area of comparability of individual approach used by banks.

The majority of corporate exposures in banks are the exposures to clients which do not have any external rating. In this area the standardized risk weights have to be applied directly. I welcome the Basel Committee proposal to establish special risk weight for bigger SMEs. This solution improves regulatory possibility to finance this type of enterprises. It restricts also the risk the cliff effect generated by prudential regulation. This effect may appear if the debtor does not meet any longer requirement to be treated as SME with risk weight 75%. I am convinced that the SMEs have smaller impact on the systemic problems in economy, they are more flexible in their business activity and this lowered risk weight is reasonable and justified.

Specialized lending

I would like to express my deep concern regarding the proposal of capital treatment of specialized lending. This proposal contains the substantially higher risk weights in comparison to the risk weights used today by banks according to existing prudential requirements. The scale of planned restriction is so high that the risk weight applied in specialized lending will be higher than risk weights in corporate exposures. The minimal risk weight after adoption of new requirements will be 120% for project finance and object finance and 150% for land acquisition. In my opinion there is not the sufficient rationale for such difference in level of risk weights for these classes of exposures.

In my opinion this regulatory approach may bring the unintended consequence for bank activity. The credit institution will be more interested in the general financing the corporates than financing specialized projects. I would like to express the view that this approach seems to be too conservative. Firstly, the nature of specialized lending is the approval by the creditor the special business plan for the financed project. It allows to separate the present complex situation of debtor from cash-flow generated by credited project. Secondly, the creditor has better possibility to control the assets which are the collateral of exposure during all process of specialized lending and in some cases also tangible cash-flow. These factors restrict in significant way the scale of losses generated in specialized lending. I am afraid the adoption of new requirement may cause in the future significant problems in area of financing of new infrastructure projects, including big projects with state contribution. These projects can be very often financed as the specialized lending only. It is worth to mention in this context that the newest European plan for economic development (so called Junkner Plan) includes the infrastructure development as one of main drivers of progress. New proposal of capital requirement may create effective burden to realization of this plan.

Retail portfolio

First of all, I would like to support the idea of higher indicator of granularity. This change goes in good direction. This problem is particularly important for the smaller banks where the actual limit can be exceeded in easy way. The enhanced level of granularity is not very high and it will not create higher risk in business activity of banks. It can be still a little higher for smaller banks in order not to discriminate business retail consumers in these banks by strict prudential regulation. In my opinion this higher level of granularity may be established as the binding regulatory standard. However, the idea included in footnote 10 on page 10 of second consultative document concerning the national discretion to remove the threshold where appropriate alternative methods are implemented is not clear for me. It allows the local jurisdiction to change the granularity level without strictly expressed reason. This approach contradicts the general idea of new requirements to minimize the scale of national discretions. I scare as well that it will be difficult for small banks to deliver the sufficient empirical analysis which can be treated as the sufficient evidence of small risk of higher level of granularity for stability of bank activity.

The general proposed treatment of retail exposures is very similar to system which exists today. I would like to put into consideration the bigger diversification of single risk weight for retail class. One risk weight for exposures does not incorporate real risk sensitivity. I would like to take into consideration the proposal to implement lower risk weight in area of secured financing, for example specialized financing of car purchase.

Real estate exposures

The proposal of revised standard contains big changes in capital treatment of this class of exposures. Generally all taxonomy is revised but the distinction between residential and commercial real estate exposures is maintained. I would like to concentrate my opinion generally on the new proposal of residential exposure treatment. In order to increase risk sensitivity the proposal of Basel Committee foresees new approach where the principal driver for setting up higher prudential requirement is to play the level of the LTV indicator.

The idea to include the LTV as the driver of risk weights applied by banks is not completely new. During previous window of consultation this proposal was already envisaged. In my opinion the LTV factor is the simplified solution in prudential requirements. In practice the level of LTV has the impact

on the behavior of debtor but the problem is more nuanced. The list of drivers of higher NPL in bank portfolio is in fact much broader and to limit it to the LTV level is not completely justified.

I may indicate the aim of financing as the critical factor of debtor readiness to repay its debt on time. The debtor which borrows the money for the acquisition of the flat used for private purpose is more willing to pay back its commitment on time than the debtor which has bought the flat for renting. The level of actual LTV indicator is very often of secondary importance in this situation. This differentiation is not taken in consideration in the proposal of new prudential requirement. It makes the proposal less risk sensitive.

The Basel Committee proposal does not foresee the impact of debt servicing coverage on the level of risk generated by exposure. This lack creates the oversimplified approach. In fact, the level of DSC has the big impact on the debtor capacity to meet its commitments. This factor may play more crucial role than the actual LTV level. I am conscious of practical problem how to assess the DSC level for each client, how to verify the information, but it is difficult to ignore this factor completely.

I would like to express my concern in area of proposed calculation of LTV indicator. This indicator is constructed in very conservative way. One element – numerator - can be changed over time in both directions but the other one – denominator - can go downward only. Additionally, the value of the property has to be kept constant at origination. I do not see rational reason why the growing price of real estate over time could not be included in the LTV calculation. These limits set up in regulatory proposal makes the indicator artificial. As consequence this approach is not fair and is too conservative.

The regulatory proposal foresees to apply one LTV indicator for whole exposure. It does not allow to divide the exposure into the secured and unsecured part. This approach should be once again analyzed in order to not make the system too punitive for some exposures. Such approach may generate the cliff effect.

Last but not least, I would like to ask for implementation of phase-out period concerning the LTV calculation requirements for prudential purpose. There is the justification of this proposal. Firstly, the impact of new proposal will be limited on situation of current borrowers or it will be negative in this way that banks start to demand additional collateral for existing exposures. Secondly, the big portfolio of existing exposures with long-term maturities has to be well managed by banks in order to meet all new requirements in one time. New regulatory approach would generate the temporary turbulence on credit market limiting the access of clients to new mortgage credits when total prudential requirements grow rapidly and banks have limited access to new capital.

Risk weight add-on for exposures with currency mismatch

The proposal presented in this area is completely new approach of the Basel Committee to the currency mismatch. Until now the currency mismatch could be applied to exposures to private clients, mainly to real estate exposures. Now the Basel Committee recommends to broaden the scope of application to the corporate exposures and even to equity and subordinated debt (as can be observed upon the current BIII monitoring exercise for the collection of data as of December 2015).

In my opinion this proposal should be once again carefully analyzed. I am afraid not all aspect have been taken into consideration before the proposal was maintained in the second consultative document. I would like to emphasize that I understand and accept the general idea of application of higher risk weights for exposures with currency mismatch in relation to individual persons. However, the case of corporate exposures is completely different. The activity and source of revenue in corporate business are usually more diversified than in the case of private persons which have limited sources of their income. Generally, the existence of currency mismatch for corporate mismatch should be part of the assessment performed in the due diligence process.

Polish long-term experience in area of the FX mortgage credit portfolio to private persons indicates that the relation between the level of credit losses and currency of exposure may be strongly limited. I may indicate that the actual level of NPL for FX mortgage credits is very similar to level of NPL for mortgage credits granted in local currency. This result was achieved one year after freeing the CHF exchange rate by Swiss central bank (where the majority of FX mortgage credits in Poland are still denominated in CHF) which have caused the weakening of local currency to CHF by 25% on annual basis. This experience is clear evidence for our banking sector, that the most important factor which can limit the NPL level is the application of conservative prudential process of granting credits by banks, not the existing currency mismatch of credit exposures.

Implementation of add-on capital requirements on the unhedged currency mismatch shall be especially unfavorable for SME corporates, which have limited access to the hedge instruments. Bigger corporates usually enter into financial hedges as they have more diversified business activities and more diversified sources of income. They have easier access to the financial hedge and therefore will maintain lower risk weight (i.e. without risk weight add-on, eg. 100% RW). As a result of risk weight add-on mechanism it may turn out that SME exposures (without financial hedges) will be assigned higher risk weights than corporate exposures (with financial hedges) which seems to be not in line with the concept to assign lower preferential risk weights for SME exposures, clearly visible in the second consultation paper of Basel Committee.

There is also the technical problem how banks should read the proposal of paragraph 62 concerning the application of add-on. One possibility is to add flat add-on risk weight of 50% to the basic risk weight applied for exposure denominated in local currency, the other is the basic risk weight applied for exposure denominated in local currency shall be multiplied by 50%. Both approach may cause different result, the exception is of course the basic risk weight equal to 100%.

It is worth to mention that the implementation of add-on risk weight for corporate exposures will generate big operational problems for banks. They will have to assess the conditions when the currency mismatch should be applied and has the impact on the potential level of credit losses. The credit institutions would have to analyze the annual statement of each debtor over time in order to look at the actual currency structure of its income and adopt the level of applied risk weights to the current situation of currency mismatch for credit exposure in following periods. This structure of revenue will probably change in many companies in essential way every year.

In fact the analysis of currency mismatch should not be limited to the current structure of revenue. Other factors should be also included in the spectrum of bank assessment. The currency of expenses may also have important impact on the currency position of debtor. The acquisition of materials may have essential impact on currency mismatch and company demand on foreign currency. The investment expenses may play similar role. What is more, there is not the structure of balance sheet of debtor which should be assessed only. The significant role may play the orders signed by debtor, especially long-term orders. For example I may imagine the situation where debtor signed order with his foreign counterparty (for example concerning ship construction) and bank has to verify if this trigger is sufficient assumption in order not to apply the risk weight add-on on debtor exposure. In regard to the different specific business profiles of corporates this approach will require the broad additional scope of information collected by banks about the current situation of many debtors. It may be burdensome for banks classify the corporate exposures in this way. The simplified approach may assume the verification of the actual structure of debtor revenue as the unique factor for application of risk weight add-on but this model seems to artificial in complicated business reality. In my opinion all above-mentioned arguments and probably many others factors should be carefully considered before the final decision will be made in area of setting up additional risk weights for company exposures with currency mismatch.

Off-balance sheet exposures

The second consultative document proposes to apply the 10-20% credit conversion factor (CCF) to retail commitments which are unconditionally cancellable at any time by banks without prior notice. I

would like to express my concern that this proposed calibration express the higher capital requirements for banks and will have the negative impact on the bank lending capacity. The banks will have limited incentives to issue such commitments in the future. They will probably demand higher fee for issuance of such commitments. All this elements may have the negative impact on real economy.

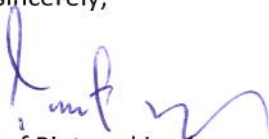
The retaining the 0% CCF is more appropriate given unconditionally cancellable character of these commitments. It is difficult to accept the general assumption expressed in the consultative document that reputational aspect in bank or the consumer protection law can successfully mitigate the readiness of banks to cancel the unconditionally cancelable commitments if there are the sufficient reasons to do it.

It is worth to mention that the capital requirements in standardized approach is also of crucial importance for calculation of the leverage ratio in bank as well. The leverage exposure for off-balance sheet items is calculated by applying this standardized approach to nominal exposure value. Therefore increasing CCFs will have the direct impact on the level of leverage ratio in banks.

I would like to recommend also to set up stricter correlation between the proposed approach and the account treatment of unconditionally cancellable commitments. Until now such commitments are not recognized under the IRFS.

I would like to thank for the progress made by the Basel Committee in recalibration of proposal since presentation of first consultative document on standardized approach for credit risk. I feel the regulator is close to set up correct prudential requirements for banks which play crucial role in their business activity. I hope the final revision of proposal and the comments received from supervisors and industry will allow to adopt the solution which will be relatively simply and risk sensitive to such extend as it is possible in one prudential regulation.

Yours sincerely,



Krzysztof Pietraszkiewicz

President