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Basel Committee on
Banking Supervision

Revisions to the Standardised Approach for credit risk

Introduction

Our main focus is on the combined effect of the Basel Committees consultations on a new standardised approach for credit risk and new capital floors. Therefore, in the summary we comment on the combined effects of the proposals. Thereafter we comment on the proposal for a new standardised approach. For detailed comments on the proposal for new capital floors we refer to our response on that consultation.

Summary

Looking at the proposal for a new standardised approach for credit risk as a stand-alone proposal (not as a reference point for disclosure and new capital floors) we can't see any urgent need for change in the current standardised approach. Most banks that use the standardised approach are small or medium-sized and focus on retail lending. For these banks the proposal will add a lot of complexity and compliance costs, without necessarily strengthening the risk sensitivity or the measurement and control of risk. Therefore, we would like to underline the importance of small and medium-sized banks being able to use a very simple standardised approach even if a more advanced standardised approach for credit risk is introduced.

If the proposed standardised approach for credit risk is to be introduced we believe that it is essential to leave room for national flexibility and calibration. We strongly oppose a one-size-fits-all model that uses the same risk drivers and the same calibration for banks all over the world. A loan-to-value of 70 per cent in one country can imply a totally different risk compared to the same loan-to-value in another country, depending on for example legal, structural and cultural aspects. Also a company with revenues of 50 million euros can be small in one country and very large in another.

External ratings represent a sound source of information about the risk in many cases. Rating information is easy to obtain and generally strongly associated with the risk of both bank and corporate exposures. It is also adapted to local conditions

and contains much more information on credit risk compared to the proposed risk indicators. We would therefore favour a continued use of external rating and also the possibility to use credit information from national credit agencies.

We strongly oppose the introduction of permanent capital floors. It is our opinion that permanent capital floors are not necessary, they will rather be detrimental to than enforcing financial stability. The reason is that risk-based capital requirements provide incentives for banks to assess and price risk correctly, while binding capital floors will give banks the wrong kind of incentives, for example to replace low risk assets with high risk assets.

Instead, it is our firm view that the use of the internal ratings-based approach should be maintained. We believe that banks that use internal rating based methods have better knowledge and control of their risk. Capital floors that are designed and calibrated incorrectly can be the binding requirement for many banks, and not the backstop they should be.

If new capital floors based on a new standardised approach for credit risk are to be introduced, they should at least not be developed and put into force until all other new capital requirements (including for example TLAC/MREL) have been implemented and the effects of them have been analysed.

Finally, it is not reasonable that the Basel Committee agrees on regulatory changes that will have huge impact on both banks and their customers in many jurisdictions, without a very thorough analysis and involvement from national authorities. The analysis must not only focus on risk weights and capital requirements, but also on how established business models for banks may change and how the customers of the banks will be affected.

General comments

In our view it is not appropriate to globally define a detailed standardised approach for credit risk to be used by thousands of banks. The conditions of these banks – in the form of, for example legal, structural and market conditions – are too different for a fully harmonised approach to work. Instead, both the risk drivers and the calibration methods should be developed nationally or regionally, based on a common set of overarching principles.

Our preliminary calculations show that the proposed risk drivers and the proposed calibration will lead to significant higher risk weights compared to the current standardised approach, which is in contradiction with the objective stated by the Basel Committee.

We are doubtful to many of the risk indicators proposed in the new standardised approach. One example is that we question whether a company's revenue (size) works better than the rating as a risk indicator. Another example is residential real estate where we believe that national differences are so large regarding e.g. legal and structural factors that it is inappropriate to calibrate risk weights to LTV buckets on a global level.

The standardised approach for credit risk is mainly used by small and medium-sized local banks, often focused on retail lending. The Basel Committee's rulemaking normally addresses internationally active banks, who most often use the IRB approach. The standardised approach should therefore mainly focus on what is appropriate for small and medium-sized nationally oriented banks.

Our conclusion is, looking at the proposal only as a revised standardised approach (and not as a reference point for disclosures and new capital floors), that it is no need for change in the current standardised approach. A revised approach will add a lot of complexity and compliance costs, without necessary strengthening the risk sensitivity of the capital requirements or the measurement and control of risk in small or medium-sized banks. Therefore we will underline the importance of small and medium-sized banks being able to use a simple standardised approach even if a more advanced standardised approach is introduced.

The potential use of a revised standardised approach as a reference point for new capital floors has in our view a far larger impact on the banking sector than the use only as a standardised approach for small and medium-sized banks. (For more detailed comments on the combined effects of the two proposals, see our response on the capital floors-consultation.)

In our view there are two important general problems with the two factor models proposed for corporate and residential real estate exposures.

First, the proposal suggests that risk drivers based on individual counterparty information shall be used to separate counterparties into different risk buckets. To create systems for measuring, reporting and monitoring these risk drivers will be very resource demanding, especially for smaller banks. For large banks the costs might be marginal, but for smaller banks they will be substantial and create a further competitive disadvantage. It will raise the barriers to entry to the banking industry. For small banks, it is hard to see that this type of burden is warranted at all. Second, the proposal is not very risk sensitive, and in some instances it might even be that some of the risk drivers are reversely correlated with risk.¹

¹ One example is the revenues for corporates measured in absolute numbers, effectively only a size related parameter. Larger companies may on an individual default risk basis generally be less risky than smaller ones. But seen in a portfolio context, when distinguishing between expected and unexpected

Moreover, it is quite obvious that national circumstances are essential both for the choice of valid risk drivers and for the calibration of appropriate levels for risk buckets. Some examples are:

- The probability of losses for households is very different if the bankruptcy law allows people to walk away from debt without severe repercussions compared to if there are no personal bankruptcy where debt is written off, meaning that the debt remains with a defaulting borrower for the rest of the borrower's life.
- The size of corporate borrowers and their riskiness cannot be measured in absolute terms, rather only in relation to the size of a particular economy. In small or emerging economies, the revenue measured in absolute terms in euros for a corporate may mean something completely different as a risk driver compared to in larger developed economies.
- Tax systems and social security safety nets will have very different implications for the residential real estate related risk driver debt service coverage (DSC). In some countries, a lot of costs for households are paid over the tax bill (for instance health care, schools etc.) while for other countries the same costs are paid by directly by the households'. These differences mean that a DSC after tax will mean something very different in a country where tax levels are high compared to a country where most living costs are paid privately and taxes are kept low. Tax burdens can for this reason differ a lot, at least between 10% and 50%. Also the amortisation behaviour can differ a lot between countries. For these reasons the relationship between the DSC and the risk of loss is likely to differ significantly between countries.

Our view is that it would be better to create simple and relevant risk drivers for corporate and retail exposures on a national level rather than on a global level. On the other hand, the Basel Committee has a preference for proposing rules that are general for banks internationally. However, corporate and retail exposures always have an origin in a particular country. And the important thing is that banks that are active in one particular country are given the same conditions when they compete on that local market. This means that it would be possible to create much better risk differentiation, and at the same time keep a level playing field, if risk weights could be decided nationally with local risk driving factors in mind. According to our mind the patterns displayed in the chart of appendix 1 confirms this view, at least in the case of residential real estate exposures.

loss, this may not at all be the case, especially for a small bank with a portfolio that may not be so granular. This view is even taken into account in the Basel formula, where companies with smaller revenue is given a lower correlation factor, effectively giving a lower risk weight to smaller companies all else equal.

If a new standardised approach is to be introduced our view is that at least risk weightings should be calibrated on a national level. The national risk weighting could then be used for all banks' corporate and retail exposures in that particular country, regardless of whether the bank is domiciled in that particular country or not. The Basel framework should still be used for defining the exposure classes and the structure of the reporting. It would be easy to compare risk weights for different countries and it would be a very transparent, and from a competition point of view, neutral application of standardised risk weights.

Specific comments

Exposures to banks

We are questioning the proposal to abandon rating as the basis for determining the risk weight for exposures to banks. Rating information is easy to obtain and generally strongly associated with the risk of a bank exposure. It is also adapted to local circumstances and contains much more information on credit risk compared to the proposed risk indicators.

If capital ratios are to be used as a risk indicator for exposure to banks, we strongly advocate risk-weighted capital ratios rather than the leverage ratio. The purpose of the leverage ratio has never been to be the primary measure of capital adequacy for banks, rather to serve as a backstop for capital requirements.

We are furthermore concerned about the treatment of covered bonds. Covered bonds are governed by specific legislation that fulfils a number of strictly defined criteria. In Sweden and in many other countries the covered bond market has performed very well even in stressed situations. It has never been reported any credit losses from exposures to covered bonds, anywhere. Covered bonds are particularly important for banks as they are eligible for liquidity reserves in respects of prudential liquidity requirements (the LCR). It is important that the cost of carrying large liquidity reserves are not unduly high, which they likely would become if covered bonds exposures are treated as other bank exposures. In our view covered bonds should have a preferential treatment compared to exposures to banks.

Exposures to corporates

For corporate exposures we believe that the counterparty's rating is generally a good basis for determining the risk weight of an exposure. It is far from obvious that the proposed risk indicators - revenue (size) and leverage - captures the risk better than the rating.

If the proposed new standardised approach will be used as a reference point for new capital floors it will affect corporate exposures disproportionately hard and be

counterproductive to the aim of creating investments for growth and new jobs. From a Swedish point of view especially lending to residential property and to large companies will be affected since the risk weights following the proposed standardised approach are significantly higher compared to what follows of the IRB risk weights.²

The proposal may have significant threshold effects for small businesses that grows and getting bigger, because the risk weight increases significantly at transition from "retail" to "corporate". According to the proposal, exposures to corporates with a revenue below 1 million Euro can be classified as retail and receive a risk weight of 75% or 100%. Exposures to corporates where the revenue is between 1 million and 5 million Euro will receive a risk weight in the range 100%-130%, depending on the entity's leverage. The risk weight will however be lower the higher the corporate's revenue is, and fall to 60% for corporate's with total revenue above 1 billion Euro and low leverage. This structure will create strange cliff effects for exposures close to 1 million Euro.

In addition we believe there are reasons to challenge the view that capital requirements in general should be higher for exposures on smaller entities than on larger ones.

According to our view capital requirements should be driven by volatility in loan losses on portfolio level, i.e, the unexpected losses, rather than by the likelihood of losses on individual clients. Banks usually charge the customers margins that are high enough to cover expected losses, or average losses, on portfolio level. Loan margins will then create the cash flow necessary to cover average losses whereas a capital cushion will be required to cover losses when they exceed the average.

Applying this logic, we would argue that although the likelihood of losses in general may be higher on exposures to small corporates than on exposures to larger entities this does not necessary mean that the capital requirement for a portfolio of many exposures to smaller companies should be higher than the capital required for a portfolio with fewer exposures on large corporates. This is because a significant part of the losses made on smaller companies are due to the owners personal circumstances (i.e. more idiosyncratic risk), whereas losses on exposures to larger entities are more driven by the general conditions of the economy (i.e. more systematic risk). In addition individual losses are in general higher for large companies than for smaller entities. This means that although loss levels may in general be higher on lending to small corporates than to the larger ones, the volatility in losses on portfolio level does not necessary need to be higher for a well-diversified portfolio of loans to smaller entities.

² See example I Appendix 2.

In EU, IFRS is mandatory on group level for listed companies but local GAAP is applied to a variable extent by other companies. In Sweden the major part of smaller companies are, in line with one of the options in the local GAAP, measuring their assets at purchase price less accumulated depreciation. These companies, in particular real estate companies, are in general showing “artificially” high leverage ratios in comparison to the companies applying IFRS. This means that the relationship between reported leverage and some kind of “true” leverage from an economical point of view could be quite stochastic. It also means that using leverage, *without taking into account other circumstances*, is according to our experience in several cases quite useless for predicting the likelihood of loss on a particular exposure.³

Retail portfolio

We agree with the proposal to keep the current 75% risk weight, mainly because of simplicity reasons. However, we would like to add an orientation criterion to cover also medium-sized business. This is a common practice in European banks.

Exposures secured by residential real estate

We believe that it is neither possible nor appropriate to globally harmonise a detailed system for risk weights for residential real estate. A variety of factors influence the risk incurred by residential lending, for example the way the housing market operates, the systems of property valuation, registration and pledge of housing and design of the legal and the welfare systems. To the extent that risk weights are to be differentiated under the standardised approach the calibration should therefore be decided on national level.

According to the proposal, the original value of the property and original DSC normally should be used during the entire lifespan of the loan. Assuming no amortisation, a mortgage loan that originally has a LTV of 80 percent and a DSC greater than 35 percent will have a risk weight of 70 per cent during the entire maturity of the loan. We believe that it is an unreasonable approach. An increased market value of the dwelling or an increased income of the borrower must be able to

³ These effects are far from marginal; consider the following example. A company with assets mainly consisting of residential property funded a portfolio of properties with 50% debt 20 years ago. Property is depreciated over 40 years according to national GAAP, meaning that after 20 years, only 50% of the initial value remains in the books. Assuming no amortisation (which may be quite realistic if the company has used excess cash flow to continuously renovate the property), the value of the property will be the same as the debt in the company's accounts. The company will then look like it is extremely levered (basically no equity left). However, assuming no growth in the market value of the property of the 20 years, the leverage is still 50%. And, assuming a more realistic rise in the market value over the 20 years on for instance 100% (3,5% annually), this means that the actual leverage is only 25%. This may look like an extreme example but it would actually be quite representative for a Swedish real estate company.

carry a lower risk weight for the exposure, otherwise both risk drivers will provide less and less information about the risk of loan losses as time elapses after the loan origination. Our conclusion is that it must be possible to calculate the risk weight based on the current market value of the property and the current DSC.

The DSC is according to the proposal based on the borrower's net income. One objection is that the net income (i.e. income after taxes and social benefits) can be difficult to control for the lender. Another objection is that net income in many cases are not comparable between countries as a result of, among other things, differences in health care and welfare systems designs (fiscal and privately funded systems).

Furthermore, the DSC includes amortisations and the indicator increases the more the customer amortises. It is according to our mind counterintuitive to assign a higher risk weight the more the customer amortise. If the DSC should be a risk indicator amortisations should be excluded from the measure.

We oppose that tranching a loan into different LTV buckets will not be allowed. One effect of the proposal is that secured loans with high LTV and high DSC will have higher risk weights than unsecured retail exposures.

In Sweden, one of the most common housing forms is housing cooperatives. Lending to housing cooperatives have proven to be safe and with very low loan losses, even during the two severe financial crisis we experienced in Sweden. In the current proposal for a standardised approach it is not clear how exposures to housing cooperatives should be treated. We are concerned that the risk weight for this kind of low risk lending might increase disproportionately.

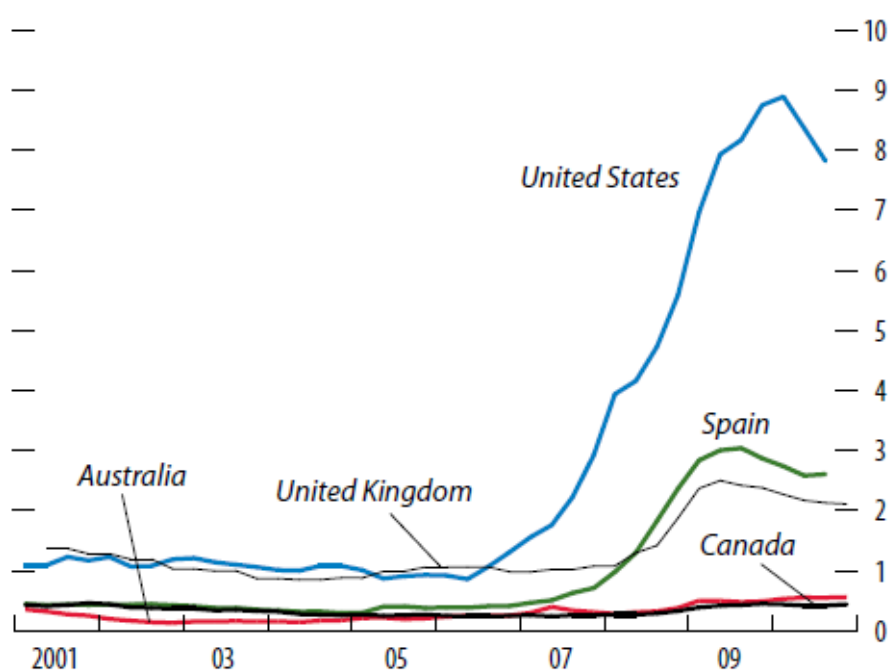
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Appendix 1. Non-performing residential mortgage loans in various jurisdictions, IMF Global Financial Stability Report, April 2011

Figure 3.8. Nonperforming Residential Mortgage Loans
(In percent of total residential mortgage loans outstanding)



Sources: Federal Reserve Bank of New York; Reserve Bank of Australia; Bank of Spain; U.K., Council of Mortgage Lenders; and Lea (2010b).

Note: Nonperforming loans that are more than 90 days in arrears. For Australia, Canada, and the U.S., banks only.

Appendix 2. Effects for lending to the corporate sector in Sweden

To illustrate the negative effects of the proposed floors for the Swedish economy, in particular the effects for the corporate sector, the following quantitative effects can be estimated.

The four large Swedish banks (that stands for approximately 70% of corporate lending and 60% of corporate credit intermediation incl. bond markets in Sweden) have an average risk weight for corporate exposures of 36%. The average risk weight may seem low, but there are a couple of important factors behind that.

Firstly, around 40% of Swedish corporate lending consists of funding for residential property, partly loans to housing associations, partly loans to companies funding multi-family houses. The way to own an apartment in Sweden is to own a share in a housing association. The shares in a housing association work in practice as if you own an apartment, you can use the share as collateral for a mortgage and it is possible to buy and sell it just as an owned apartment. The funding of the apartment building is typically done through the individuals mortgaging the shares, but the housing associations can also take on some debt, for instance for renovation projects. The cost of those loans is then part of the monthly fee that the owners of the shares pay to the housing associations. Loans to housing associations make up for around 20% of Swedish corporate lending. The risk in lending to the housing association is obviously very low, since the outstanding loans typically are very small compared to the value of the property and since the housing association have the possibility to adjust its payment capacity through debiting the owners of the shares for the cost of lending. The banks have been able to prove in the internal models approach that lending to housing associations have very low risk. The credit losses were low both in the stress of 2008 and 2009 and in the very severe banking crisis of the 1990's.

In Sweden, rental apartment buildings are to a high degree owned by municipality owned companies, who normally fund part of the buildings through mortgages in banks. The leverage is typically low, below 50%. Due to rent regulation, cash flows from the rental contracts are extremely stable. The rental regulation also leads to very stable cash flows for the privately owned part of the rental market. This has also lead to low losses for multi-family housing credits, which are reflected in the IRB calculated risk weights for the banks.

Another important part of corporate lending in Sweden is lending to large internationally diversified companies, often in the export industry, that typically also has a low leverage and stable cash flow. These companies are very important for the Swedish export driven economy. The larger companies are also dependent on a much more granular SME sector, consisting of subcontractors to the export industry.

Given the structure of the corporate sector, and the way that the risk factors are chosen in the proposed standardized approach, it is unlikely that the corporate sector would get an average risk weight that is very different from the 100% level. Some larger companies may benefit from lower risk weights, but some of the residential companies would probably get a higher risk weight than that, especially because of the fact that national accounting standards means that property values are recognised at purchase price less accumulated depreciations,

meaning that a lot of these companies would look artificially levered, when the property values in the accounts often will be only a fraction of the market value.

Assuming a new floor at 80%, this would mean that capital requirements would more than double for the corporate sector (from the average risk weight of 36% to an average of roughly 80%). As a lot of developed economies, Sweden is in deep need of increased investments, in order to be able to sustain reasonable economic growth in the long run. The central bank is at present exploring options to increase the supply of credit and to increase demand. Investments are important not the least within the sectors that will be worst hit by the rise in capital requirements. Furthermore, one reason for residential property to be highly valued in Sweden is that new construction has been low for a long time, and that Swedish property owners typically keep the value of the properties through ambitious and continuous renovation programmes. It is important that borrowed capital does not become much more expensive for those projects. The export sector that typically leads Swedish growth is also highly dependent on continuous investments in machinery and production equipment.

To double the capital requirements for corporates, which in turn will significantly increase interest rates, seems from this background to be extremely counterproductive, especially since capital requirements have already increased significantly after the financial crisis. This increase looks even more awkward when taking into account the fact that the Swedish banks have proven to be one of the most prudent banking sectors throughout the financial sector, showing very low losses for the domestic exposures even in the crisis of 2008-2009, when GDP in Sweden fell by 5%.