



March 26, 2015

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

Re: Comments in Response to Consultative Documents—Revisions to the
Standardised Approach for Credit Risk and Capital Floors: The Design of
a Framework Based on Standardised Approaches.

Ladies and Gentlemen:

The Clearing House Association L.L.C. (“**The Clearing House**”)¹ appreciates the opportunity to comment on the consultative document by the Basel Committee on Banking Supervision (the “**Basel Committee**”) entitled “*Revisions to the Standardised Approach for Credit Risk*” (the “**Credit Risk Proposal**”)² and certain aspects of the companion consultative document entitled “*Capital Floors: the Design of a Framework Based on Standardized Approaches*” (the “**Capital Floor Proposal**” and, together with the Credit Risk Proposal, the “**Proposals**”).³

¹ Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world’s largest commercial banks, which collectively hold more than half of all U.S. deposits and which employ over one million people in the United States and more than two million people worldwide. The Clearing House Association L.L.C. is a nonpartisan advocacy organization that represents the interests of its owner banks by developing and promoting policies to support a safe, sound and competitive banking system that serves customers and communities. Its affiliate, The Clearing House Payments Company L.L.C., which is regulated as a systemically important financial market utility, owns and operates payments technology infrastructure that provides safe and efficient payment, clearing and settlement services to financial institutions, and leads innovation and thought leadership activities for the next generation of payments. It clears almost \$2 trillion each day, representing nearly half of all automated clearing house, funds transfer and check-image payments made in the United States. See, The Clearing House’s web page at www.theclearinghouse.org.

² Basel Committee, Consultative Document: Revisions to the Standardised Approach for Credit Risk (Credit Risk Proposal) (December 2014), *available at*: <http://www.bis.org/bcbs/publ/d307.pdf>.

³ Basel Committee, Capital Floors: the Design of a Framework Based on Standardised Approaches - Consultative Document (December 2014), *available at*: <http://www.bis.org/bcbs/publ/d306.htm>.

The Credit Risk Proposal's stated goals are to revise the Basel Committee's current standardized approach for credit risk (the "**Standardized Approach**")⁴ primarily by reducing reliance on external credit ratings, increasing risk sensitivity, and strengthening the comparability of risk weighted asset calculations as between the Standardized Approach and the Basel Committee's advanced internal ratings-based approach (the "**Advanced Approach**"),⁵ while continuing to ensure that the Standardized Approach remains "simple, intuitive, readily available and capable of explaining risk across jurisdictions."⁶

As an overarching matter, The Clearing House strongly supports the maintenance by banking organizations of robust and risk-appropriate capital levels and the Basel Committee's efforts to improve the Standardized Approach. Our comments are designed to identify areas where we believe the Credit Risk Proposal should be modified to better support the Basel Committee's stated objectives. Even at a conceptual level, however, our ability to meaningfully comment is limited in the absence of a fulsome quantitative analysis of the Proposals. We believe that the Basel Committee's efforts to gather data through a quantitative impact study ("**QIS**") is crucial to the development of the Credit Risk Proposal's modifications to the Standardized Approach and the Capital Floor Proposal—both as to their respective calibration and, perhaps even more importantly, as to the conceptual underpinnings of the revised frameworks themselves. Simply put, the Proposals' analytical rationales cannot be fully evaluated in the absence of the QIS data whereby the proposed changes are tested against real world data. For example, and as described in further detail below, QIS data may demonstrate that the use of a "one size fits all" leverage metric for corporate exposures may not properly recognize legitimate differences in acceptable levels of leverage across industries. Accordingly, our comments reflect our preliminary views, which we intend to supplement over time as further information becomes available both as part of our own data collection efforts and analysis and in response to the results of the QIS.

Part I of this letter provides an executive summary of our comments; Part II discusses our comments to the Proposals relating to specific exposure classes; Part III of this letter sets forth our comments on the proposal on credit risk mitigation; Part IV of this letter addresses the importance of national discretion as it relates to the application of the Proposals and the intersection with otherwise existing domestic law; and Part V sets forth our comments with respect to the Capital Floor Proposal.

I. Executive Summary

The Credit Risk Proposal is an important first step in updating the assessment of credit risk under the Standardized Approach. Modifications to the current Standardized Approach are of particular importance to U.S. banking organizations because of their potentially significant impact in the United States. Due to binding legislation, all U.S. banking organizations are required to calculate their risk-based capital ratios under the U.S. version of the

⁴ See, Basel Committee, Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version (Basel II) (June 2006), *available at*: <http://www.bis.org/publ/bcbs128.htm>.

⁵ See *id.*, at ¶¶ 211-537.

⁶ Credit Risk Proposal at page 5.

Standardized Approach (the “**U.S. Standardized Approach**”) that was finalized in 2013 and only came into effect on January 1, 2015,⁷ including as an absolute statutory floor for organizations that calculate their risk-based capital ratios under the U.S. version of the advanced approach rules (the “**U.S. Advanced Approach**”).⁸ Accordingly, any changes to the calculation of the Standardized Approach—if and when adopted by the U.S. Federal banking agencies—may necessarily have a direct impact on many U.S. banking organizations by requiring the application of both the legislatively required minimum U.S. Standardized Approach and some version of the revised Basel Standardized Approach. By contrast, modifications to the Standardized Approach may not fully and immediately affect banking organizations in other jurisdictions that are subject to only the Advanced Approach. Although the Basel Committee is contemplating adopting the Standardized Approach as a capital floor as an international standard, today many banking organizations in other jurisdictions do not calculate their risk-based capital ratios under the Standardized Approach and are not subject to a capital floor to the same extent as U.S. banking organizations.

In the absence of the completion of the QIS and release of the related data, our initial comments and recommendations as the Basel Committee continues to develop the Credit Risk Proposal include:

- We agree that “[c]apital charges from the standardised approach should reflect to a reasonable extent the risk of the exposures and provide the correct incentives for banks considering the overall policy objectives. The standardised approach should provide a meaningful differentiation of risk with the ultimate goal of improving ex post risk sensitivity.”⁹ We are concerned, however, that some of the proposed alternatives may undermine rather than support these goals or introduce new risks.
- The use of a leverage and revenue measure for corporate exposures, for example, potentially runs counter to the goals of risk sensitivity because they may be inappropriate to certain industries that traditionally have high leverage and/or lower revenues. The proposed methodology may also lack transparency and may be problematic to actually implement because these measures are not readily available for all relevant entities or differences in accounting standards undermine their comparability. In addition, the proposed use of leverage and revenue metrics to investment fund exposures grossly overstates the risk associated with funds.
- While we understand that all of the revised risk weights will be reconsidered as a result of the QIS, the calibrations proposed for banking organization exposures and the credit conversion factors (“**CCFs**”) for commitments do not accurately reflect the actual risk involved and are contrary to historical experience. Proper calibration of the CCF for commitments is important, given the number of other prudential rules that reference

⁷ See, 12 CFR parts 3, subpart D; 217, subpart D; 324, subpart D. The U.S. Standardized Approach is based on the Basel Committee’s Standardized Approach, but contains important differences such as the elimination of the use of credit ratings for any purposes consistent with the Dodd-Frank Act and generally higher risk weights for mortgage exposures.

⁸ 12 U.S.C. § 5371; 12 CFR 3.10(c); 217.10(c); 324.10(c).

⁹ Credit Risk Proposal at 5.

the CCFs in the Standardized Approach, and thus the potential for, and depth of, market impacts.

- Although we support the concept behind the use of the common equity tier 1 capital (“**CET1**”) and non-performing assets (“**NPA**”) ratios as indicators for measuring the riskiness of exposures to banking organizations, we believe it is important to ensure that these indicators, especially the NPA ratio, are measured and publicly disclosed in a uniform manner across jurisdictions. Moreover, we believe it is imperative for the Basel Committee to carefully calibrate the Standardized Approach risk weights resulting from such methodology based on the QIS data so that it is appropriately risk sensitive as an empirical matter.
- The proposed credit risk mitigation framework would significantly overstate credit risk, while narrowing the universe of “eligible financial collateral” in a manner that is contrary to established and considered market practice. These changes would have significant consequences for important areas of economic activity, such as securities financing transactions (“**SFTs**”), and undermine banking organizations’ ability to rely on traditional and reliable credit risk mitigation practices. The Basel Committee should establish a dedicated work stream tasked with identifying an alternative and appropriately risk-sensitive non-internal model-methodology for the measurement of exposures to SFTs. Furthermore, potential modifications to the existing credit risk mitigation framework should take into account, as part of a QIS or other analysis, other regulatory initiatives that either are designed to address the same concerns or that are likely to have a significant impact on participants in the market for affected products.¹⁰ In addition, the proposed exclusion of credit derivatives without a restructuring clause as eligible financial collateral would have a particularly negative and unwarranted impact in the United States where market practice has not required such clauses due to the application of specific aspects of existing U.S. insolvency law under the U.S. Bankruptcy Code.
- While we acknowledge that one of the Credit Risk Proposals’ stated goals is to reduce the areas of national discretion¹¹ in implementing the Standardized Approach to credit risk, national discretion does not in and of itself lead to problematic outcomes from a systemic perspective where that national discretion furthers the goals of robust and appropriate capital levels, including through implementations of a binding Standardized Approach that results in capital requirements that are, in the aggregate, at least as stringent as required under the Credit Risk Proposal. We believe this is particularly important in the United States where, without appropriate national discretion in this

¹⁰ We note that the regulatory authorities in the United States are considering imposing a number of capital and liquidity penalties for SFTs, such as the proposed short-term wholesale funding framework in the capital surcharges for global systemically important banks. See, Board of Governors of the Federal Reserve System, Risk-Based Capital Guidelines – Implementation of Capital Requirements for Global Systemically Important Bank Holding Companies, 79 Fed. Reg. 75,473 (December 18, 2014). We believe that any proposed treatment of SFTs should be analyzed holistically in the context of other proposals so that the capital treatment of such transactions is commensurate with their underlying risk.

¹¹ Credit Risk Proposal at page 3.

area, the U.S. Federal banking agencies would be faced with the unfortunate choice of having to apply both the legislatively required minimum U.S. Standardized Approach and some version of the revised Basel Standardized Approach to at least some subset of U.S. banking organizations. This would have the effect of increasing material deviations for the global standard, causing further disharmonization of capital standards, decreasing transparency, and significantly increasing complexity. The Basel Committee's peer review process could be used to ensure that this national discretion is indeed used appropriately in practice.¹²

- In finalizing a Capital Floor Proposal, we strongly urge the Basel Committee to choose an "aggregate floor" approach and to not finalize such a floor until the many aspects of the Standardized Approach and Advanced Approach risk-weighting frameworks that are currently being revised have been finalized and their impacts measured. An appropriately calibrated aggregate floor approach should provide a sufficient basis for ensuring the capital comparability of institutions subject to the Standardized Approach and the Advanced Approach and will provide a sufficient check against any material discrepancies in an institution's internal models. It would also be more transparent to market participants and introduce the least amount of complexity.

II. Proposals on Exposure Classes

A. Exposures to Banking Organizations

1. Change to Exposure Methodology

To reduce the reliance on external credit ratings, the Credit Risk Proposal provides two new potential methods for risk-weighting exposures to banking organizations: (1) a risk-weighting based on the banking organization's CET1 ratio; or (2) a risk-weighting based on the banking organization's NPA ratio. As a conceptual matter, the use of CET1 or NPA ratios to measure exposures to banking organizations has merit. These measures, however, are not without potential stumbling blocks, primarily because the measures may not be consistent across jurisdictions, especially in the case of the NPA ratio. Although we support each measure as a conceptual matter, the exposure methodology cannot be fully understood or evaluated in the absence of the resulting calibration.

Due to material differences in implementation of the Basel III risk-based capital framework across jurisdictions, once broadly implemented, even the minimum CET1 ratio will not necessarily be uniform across all jurisdictions. Some jurisdictions have adopted minimum CET1 ratios that are in excess of the minimum requirements set forth in the Basel III capital accords, for example, by raising minimum requirements or creating higher effective minimums through their stress testing and capital plan review processes. In addition, the adoption of a capital surcharge for global systemically important banks pursuant to the Basel Committee's

¹² See, e.g., Basel Committee, Implementation of Basel Standards-Regulatory Consistency Assessment Programme (RCAP), available at: <http://www.bis.org/bcbs/implementation.htm>.

framework¹³ will inherently lead to variability in minimum CET1 ratios for institutions depending on their size and complexity. A calibration that relies on a banking organization's current CET1 ratio will view institutions that are subject to higher minimum capital requirements more favorably than institutions in jurisdictions with lower requirements, even where other risk factors would indicate that both institutions are an equivalent credit risk. The issue of comparability across jurisdictions is even more acute in respect of the NPA ratio, where differing national accounting standards and definitions of exactly what constitutes a non-performing asset could very well result in different NPA ratios in different jurisdictions that are not necessarily related to the actual risk posed by the reporting banking institution. In addition, as the Basel Committee notes in the Credit Risk Proposal, for global systemically important banks that are subject to a capital surcharge, the reliance on a banking organization's current CET1 ratio could increase interconnectivity among banking organizations by providing beneficial capital treatment for increasing interconnectivity with these organizations.¹⁴

Therefore, the calibration of these measures will be key to addressing these potential anomalous consequences. For example, a calibration that is based on whether a banking organization meets or exceeds its applicable minimum CET1 ratio rather than based on its current CET1 ratio would help mitigate this particular concern.

Finally, disclosure regimes vary across jurisdictions. If the Basel Committee adopts an approach that relies on a banking organization's current CET1 or NPA ratio, the Basel Committee should encourage uniform and robust disclosure in order to make the usage of these indicators practical across as many banking organizations as possible.

2. Calibration of Risk Weights

The Credit Risk Proposal would raise the minimum banking organization exposure risk-weighting from 20 percent to 30 percent. Separately, the use of the CET1 and NPA ratios, rather than reliance on sovereign credit risk, generally may impose higher risk-weightings for exposures to banking organizations. We believe that the current 20 percent minimum risk-weighting accurately captures current low-risk exposures to banking organizations. For example, this risk-weighting reflects normal course low-risk inter-bank transactions that are necessary to support payments and settlements in financial markets. A higher risk-weighting, whether as a result of the increase in the minimum risk weight or the use of a new methodology, would exaggerate the actual credit risk and would therefore be inconsistent with the Credit Risk Proposal's objective of increasing risk sensitivity. Unless the results of the QIS clearly demonstrate that a higher risk-weighting is required, we believe that the 20 percent floor should be maintained.

B. Corporate Exposures

To reduce the reliance on external credit ratings, the Credit Risk Proposal proposes a new method for risk-weighting exposures to corporates that is based on the

¹³ Basel Committee, Global Systemically Important Banks: Updated Assessment Methodology and Higher Loss Absorbency Requirement (July 2013), *available at*: <http://www.bis.org/publ/bcbs255.htm>.

¹⁴ Credit Risk Proposal at page 11.

company's leverage and revenue. We are concerned that the use of a "one size fits all" leverage metric that does not recognize differences in acceptable levels of leverage across industries will result in miscalibrated exposures. Moreover, we note that revenue metrics are not sufficiently transparent or comparable across jurisdictions, due to differences in accounting standards, to warrant usage as an exposure methodology. Thus, we recommend an exposure measurement methodology based on a concept of "investment grade," similar to the alternative framework proposed for eligible financial collateral and similar to the concept found in the U.S. capital framework.¹⁵

1. Primary Recommendation: Adoption of "Investment Grade" Standard

Many industries, such as utilities, cable companies, insurance companies, and telecommunications companies operate with different amounts of leverage acceptable to the market. These companies typically have stable cash flow sources and can operate at levels of leverage that are higher than other, more cyclical industries. A "one size fits all" approach that relies on the current leverage of such companies may unduly raise the applicable risk-weighting in a manner that is not commensurate with the underlying risk. It may also be difficult for banking organizations to obtain accurate information relating to the current leverage and revenue of a company, particularly for companies that are not publicly traded. In addition, leverage measurement and revenue recognition practices, in particular, are sensitive to accounting standards, which may be substantially different across jurisdictions. As a result, comparability across jurisdictions will likely be impaired in practice. Even when such information is available, the Credit Risk Proposal's approach would impose a significant operational burden on banking organizations to procure and process these metrics on a continuous basis, particularly for smaller institutions and U.S. banking organizations that are required to calculate their risk-based capital ratios under the Standardized Approach.

An approach that relies on whether a company is "investment grade" would, in contrast to the use of a leverage metric, promote comparability across companies in various industries and would provide a simple alternative to the use of external credit ratings. On a preliminary basis, we recommend that an investment grade company would receive a risk-weighting of 60 percent, which corresponds to the floor in the Credit Risk Proposal, and for companies that are not investment grade, a risk-weighting of 130 percent, which generally corresponds with the highest exposure.

Investment grade status is the strongest basis for assigning credit exposure risk-weights to corporate exposures for several reasons. First, investment grade status focuses on the key criterion of credit risk—a counterparty's ability to meet its financial obligations, considering all relevant circumstances—which is the core counterparty credit risk issue facing banking organizations. As such, an investment grade-based test would be appropriate for all

¹⁵ Under the proposed definition, a company's exposures are investment grade when the company "has an adequate capacity to meet its financial commitments under the security for the projected life of the asset or exposure; meaning that: (i) the risk of default by the obligor is low and (ii) the full and timely repayment of principal and interest is expected." Credit Risk Proposal at page 22. We note that this definition is also consistent with the U.S. definition of "investment grade." See, 12 CFR 3.2; 217.2; 324.2.

corporate counterparties, irrespective of the exact revenue or leverage practices within a particular industry.

Second, while investment grade determinations involve qualitative judgments, regulators can establish rigorous standards for banks to make such judgments, thereby combining strong regulatory oversight with bank credit department expertise. The U.S. Federal banking agencies, for instance, have established strong investment grade standards for corporate counterparties, which are periodically revised and updated to reflect market experience. For example, under 2012 supervisory guidance, U.S. banking organizations are directed to consider up to 13 key factors for determining investment grade status, with the application of factors varying by exposure category. More detailed guidance is provided for exposure classes that present more complex evaluation questions, such as structured securities.¹⁶

Third, an investment grade-based approach corrects for the weaknesses in a pure leverage/revenue risk-weight test, which include justifiable variations in leverage and revenue norms across industries; an absence of uniform, standardized disclosure practices across all corporate counterparties, including unregulated entities; and the existence of other relevant credit risk indicators that are ignored by a pure leverage/revenue test, such as debt trading values. In sum, an investment grade-based approach facilitates a holistic evaluation of counterparty credit risk and reinforces the responsibility of bank credit departments to apply critical thought when evaluating counterparties as opposed to simply consuming leverage and revenue data feeds without emphasis on expert judgment and responsibility.

2. Alternative Recommendation: Sub-categories of Corporate Exposures

We believe that investment grade status provides the strongest basis for making counterparty credit risk determinations. Should the Basel Committee nevertheless decide to adopt a counterparty credit risk framework based solely on quantitative metrics instead of one grounded on holistic investment grade determinations, we believe that such quantitative metrics should be refined within three or four major sub-categories of corporate exposures to better capture actual credit risk. Without introducing undue complexity into the capital framework, it should be relatively simple to identify key quantitative risk indicators relevant for such corporate exposure sub-categories, taking into account business practice differences across regions.

More specifically, we believe that a leverage/revenue test is a poor counterparty credit risk measure for most fund counterparties, which are not drivers of substantial amounts of revenue and which include a wide range of entities, regulated and

¹⁶ See, Office of the Comptroller of the Currency, Guidance on Due Diligence Requirements in Determining Whether Securities Are Eligible for Investment, at 4, *available at*: <http://www.federalreserve.gov/bankinforeg/srletters/sr1215a1.pdf>; Federal Deposit Insurance Corporation, Guidance on Due Diligence Requirements for Savings Associations in Determining Whether a Corporate Debt Security Is Eligible for Investment, 77 Fed. Reg. 43,155 (July 24, 2012), *available at*: https://www.fdic.gov/regulations/laws/federal/2012/2012-07-24_final-guidance.pdf; Board of Governors of the Federal Reserve System, Supervision & Regulation Letter 12-5: Investing in Securities without Reliance on Nationally Recognized Statistical Rating Organization Ratings (November 15, 2012), *available at*: <http://www.federalreserve.gov/bankinforeg/srletters/sr1215.pdf>.

unregulated, with very different credit quality and liquidity profile of their assets. For example, a regulated pension fund with very high-quality assets and low default risk might nonetheless become subject to a punitive risk-weight because of low revenue, even where low revenue is consistent with the overall management and design of the pension fund's balance sheet assets. Similarly, by the nature of their businesses and the applicable regulatory regime, regulated entities such as mutual funds may pose low credit risk irrespective of leverage or revenue measures. Likewise, many leveraged funds rely on credit support from outside investors, thus reducing their risk of default. Stated simply, the leverage/revenue calibrations in the Credit Risk Proposal would result in odd outcomes for many fund counterparties, with risk-weights detached from underlying credit risk profiles.

In addition to fund counterparties, we believe that there may be better methods of assessing the credit risk of corporate counterparties with public debt outstanding than a mechanistic reliance on a generic leverage/revenue test. Accordingly, and if the Basel Committee elects to not adopt an investment grade-based counterparty credit risk standard, we encourage it to explore the development suitable quantitative credit risk criteria tailored for defined sub-categories of corporate exposures in place of a simple leverage/revenue test. Preliminarily, we believe that it would be useful to consider at least three such sub-categories, including (i) funds, (ii) corporates with public debt outstanding, and (iii) other corporate counterparties.

Although specific criteria would need to be developed based on further analysis and empirical observation, we preliminarily believe that, in the case of funds, regulatory status may provide an initial basis for assigning lower risk-weights. For example, where a fund entity is subject to financial control and disclosure standards and defined limits on its investment portfolio, a risk-weight of 60 percent might apply. In the case of unregulated funds, the risk-weight would be based on one of several criteria, taking into account the fact that low credit risk funds may hold either very liquid assets or high-quality assets with less liquidity. An appropriate credit risk framework might include quantitative tests for either scenario, assigning lower risk-weights where the fund's assets either meet a minimum liquidity standard or the fund is otherwise not over-leveraged relative to its assets. Standardization could be accomplished by relying on accounting disclosures. For example, for liquidity, we believe that a useful and readily accessible proxy is the hierarchy of assets prescribed in both U.S. generally accepted accounting principles (FAS 157) and international financial reporting standards (IFRS 13).

Similarly, the credit risk framework might consider objective, publicly available measures such as corporates with public debt outstanding. Again, the development of a precise standard would require analysis and empirical work to fully validate.

Finally, the residual category of other corporate counterparties would include small businesses with limited financial histories, privately held companies with very strong credit profiles, and various types of entities that raise financing primarily through bank loans as opposed to the public debt markets. To best capture the variances in this residual group, an appropriate quantitative-based standard might include two or three alternative benchmarks for establishing risk-weights, thereby providing a degree of needed flexibility to encompass the wide range of corporate counterparties. For example, a special risk-weight may be appropriate for asset-based loans that have strong collateral support and are subject to the type of rigorous

risk-management programs associated with asset-based financing (*e.g.*, borrowing base advances, regular field audits, and strong borrower reporting requirements).

As noted above, we strongly believe that an investment grade standard strikes the correct balance between regulatory standardization of risk-weights and appropriate qualitative judgments within bank credit departments. The alternative proposal summarized in this section represents an effort to improve upon the simple leverage/revenue test in the Credit Risk Proposal by recognizing that the diversity and range of corporate counterparties will be poorly served by a uniform quantitative standard. The preliminary sub-categories discussed in this letter are offered as starting points for a more comprehensive evaluation of quantitative metrics for corporate exposures but would naturally require further validation and testing, and the boundaries and standards of some proposed sub-categories might evolve in the process. If the Basel Committee rejects an investment grade standard, we would welcome the opportunity to discuss how a corporate sub-category credit risk approach might be fully developed into complete empirical standards that could be reliably applied in all jurisdictions, which would build off of the preliminary concepts discussed in this section.

3. Provisions for Materiality

In addition, the Credit Risk Proposal raises questions about how the new risk-weight framework for corporate exposures will interact with other elements of the Standardized Approach, such as provisions for materiality (*i.e.*, non-significant equity investments). We seek confirmation that the Basel Committee intends to retain the provisions for materiality in the Standardized Approach, although the new risk weights anticipated in the Credit Risk Proposal would apply after relevant thresholds are met.

C. Exposures Secured by Residential Real Estate

To increase the risk-sensitivity and harmonize global standards in this exposure category, the Credit Risk Proposal would risk-weight exposures secured by residential real estate by the loan-to-value (“LTV”) ratio of exposure. In addition, to further increase the risk sensitivity of such exposures, the Credit Risk Proposal notes that the Basel Committee is considering a second factor, a “debt service coverage” (“DSC”) ratio, to take into account a borrower’s ability to service his or her mortgage debt. We support the Basel Committee’s efforts to ensure that the risk weights for residential mortgage loans appropriately reflect the relative riskiness of different types of mortgage exposures. Given the importance of residential mortgages to consumers and the financial system more broadly, we believe it is critical that any adjusted risk weights be appropriately calibrated to the actual risk of the relevant exposure so that the capital rules do not, on the one hand, act as an impediment to prudent mortgage lending, homeownership, and credit availability or, on the other hand, create unintended incentives for lenders to favor risky loans over safer loans. In light of the foregoing, we support the introduction of the LTV ratio, but believe that a DSC ratio is not an appropriate indicator of borrower risk.

The usage of LTV ratios (a commonly used metric for continuously evaluating the risk associated with residential mortgages) appropriately introduces additional risk sensitivity into the measurement of residential mortgage exposure. Moreover, we support the Basel Committee’s approach to reduce the cyclicalities in housing values by requiring that the

value of the property (the denominator of the LTV ratio) remain constant at the value calculated at origination. Additionally, given the idiosyncratic nature of domestic residential mortgage markets, we suggest that the Basel Committee explicitly recognize the appropriateness of national discretion in implementation relative to this asset class, such as by including an 80 percent LTV loan within the 50 percent risk weight to mirror the terms of the U.S. conventional (*i.e.*, government-sponsored-enterprise-eligible) mortgage.

We do not believe that the introduction of a DSC ratio is appropriate, however, because it is not a reliable indicator of risk. A DSC ratio would not, for example, appropriately measure the risk associated with high net worth borrowers with relatively lower yearly incomes. If the Basel Committee determines that additional risk sensitivity is needed beyond the LTV ratio, there are other metrics that are more accurate measures of risk, such as credit scores (which reflect borrower payment performance more broadly) and borrower wealth that have traditionally been a more reliable indicator of default risk. If the DSC ratio nevertheless is adopted by the Basel Committee, at a minimum, it should look to the borrower's gross income, rather than income net of taxes. It will be difficult to calculate the net income of a borrower due to substantial differences in tax regimes, even within a jurisdiction, and variability of borrowers' expenses. This would impose additional operational burdens on banking organizations to collect this information without much added benefit with respect to the DSC ratio. Moreover, a gross income approach would generally correspond with current market practice, especially in the United States, and any adoption of an alternative approach would require a significant restructuring in type of information collected from borrowers. Due to the variability in how borrower information is recorded between jurisdictions, we urge the Basel Committee to provide for national discretion in this regard to permit local regulators to implement an income-based metric that is appropriate for the relevant jurisdiction.

In addition, we urge the Basel Committee to recognize that the information may simply not be available to establish the appropriate risk weight under the proposal for legacy residential real estate exposures, that is, those originated prior to implementation of these proposed revisions. For example, establishing the LTV ratio of a loan under the proposed definition would require consideration of all other loans secured with liens of equal or higher ranking than the banking organization's lien securing the loan at the time of origination. This particular formulation of the loan's combined LTV ratio may not be available to a holder in due course, especially if the banking organization did not originate the loan itself. Similarly, banking organizations would very likely not be able to calculate the DSC ratio as proposed for legacy residential mortgages, lacking the total income net of taxes for the borrower at origination. In light of these concerns, we urge the Basel Committee to provide appropriate flexibility for the treatment of legacy residential real estate exposures for purposes of the Credit Risk Proposal once finalized.

D. Exposures Secured by Commercial Real Estate

The Credit Risk Proposal seeks to introduce risk sensitivity to the treatment of exposures secured by commercial real estate with two potential options: (1) ignoring the commercial real estate collateral and treating the underlying exposure as an unsecured exposure; or (2) risk-weighting the exposure based on the LTV ratio. The second option, which recognizes the value of commercial real estate as collateral to an appropriately limited extent, more accurately captures exposures secured by commercial real estate. However, according to

the Credit Risk Proposal, the Basel Committee is considering requiring that an exposure that is secured by commercial real estate not be “materially dependent upon the performance of, or income generated by, the property securing the mortgage, but rather on the underlying capacity of the borrower to repay the debt from other sources.” We believe that this proposed requirement is far too limited and would disqualify the vast majority of commercial real estate mortgages in the United States for this risk-weighting, instead treating them as “specialized lending,” including many lending categories that performed well in the financial crisis through carefully designed credit risk management practices, which in some cases incorporated vehicle structures. The exclusion of rent and other income generated from the property overstates the risks associated with the property and ignores a principal loan repayment source.

The exclusion of all income producing commercial real estate exposures from the commercial real estate exposure methodology would effectively treat all of these exposures the same, regardless of borrower type and stability of cash flow, under the single specialized lending category. We appreciate the Basel Committee’s desire to balance simplicity and risk sensitivity and suggest, if this exclusion is retained, that the Basel Committee, at a minimum, further differentiate between income producing commercial real estate with more stable cash flows and those with less stable cash flows rather than treating all of these exposures with a “one size fits all” approach under the specialized lending category. The more granular bucketing by LTV in the Credit Risk Proposal’s commercial real estate exposure section is a more appropriate metric for assessing income producing commercial real estate exposures with lower leveraged borrowers and more stable cash flows. As such, we believe these exposures should be captured under the commercial real estate exposure category. We are ready to engage in further dialogue with the Basel Committee to accurately determine how to best define the “stability of cash flows” within this exposure category.

E. Off-balance-sheet Exposures

The Credit Risk Proposal proposes two key changes to the treatment of off-balance sheet commitments and the related CCFs: (1) imposing a 10 percent CCF to all unconditionally cancellable commitments (the current Standardized Approach applies a zero percent CCF); and (2) applying a single 75 percent CCF for conditionally cancellable commitments (whereas, the current Standardized Approach applied a 20 or 50 percent CCF depending on the remaining maturity). These revisions seek to address what the Basel Committee identifies as “outdated calibration[s] of [CCFs]” and “the lack of consistency and comparability with the” Advanced Approach. Although we understand that the Basel Committee intends to base the final calibration on the results of the QIS, the preliminary CCFs chosen by the Basel Committee overstates the risk associated with commitments and reflects bias towards increasing the calibrations with no explanation for why the existing calibrations are “outdated.” An overstated calibration of the CCF for commitments would have an effect beyond the Credit Risk Proposal as the calibration also has an impact on a bank’s leverage ratio, its systemic indicator score under the surcharge for global systemically important banks, and the large exposure framework, which greatly increase the potential for, and depth of, market impacts. We recommend that any recalibration should be deferred until a comprehensive study of the risk and historical drawdown rates associated with commitments has been done, the QIS is complete, and the effects from the interrelationships with other frameworks has been fully evaluated. Because the Standardized Approach may be the binding constraint for many banks, a

calibration that overstates the risk of these exposures could impede banks' important financial intermediation activities.

1. Unconditionally Cancellable Commitments

A 10 percent risk-weighting for unconditionally cancellable commitments is unwarranted because a banking organization can unilaterally cancel these commitments and eliminate the risk, and, as an empirical matter, banking organizations have indeed cancelled such commitments in the past, even during the financial crisis despite any residual reputational concerns. The Credit Risk Proposal explains that a zero percent CCF for unconditionally cancellable commitments is inappropriate because "consumer protection laws, risk management capabilities and reputational risk considerations may constrain banks' ability to cancel such commitments." We believe that such considerations have not restricted banking organizations' ability to cancel many types of commitments, such as credit card lines. Therefore, the proposed 10 percent CCF would be inappropriate for such exposures.

Historical data demonstrates that banking organizations have unilaterally cancelled these commitments and eliminated the risk during periods of stress. For example, the Federal Reserve Bank of New York Quarterly Report on Household Debt and Credit¹⁷ shows that limits on credit card lines of credit fell by 12 percent during the recent recession in the United States, demonstrating credit card issuers' ability and willingness to manage risk prudently by reducing outstanding lines of credit to limit their exposure, regardless of any perceived reputational risk. Furthermore, several qualitative studies show evidence of banking organizations taking these risk management actions during the past financial crisis.¹⁸ Additionally, unlike other forms of credit, credit cards are not designed to provide liquidity, but are primarily used to make purchases. As a result, to the extent customers reduce their overall purchases, credit card balances stay flat or decrease. The same Federal Reserve report shows that credit card balances decreased during the recent recession, coinciding with qualitative indicators of reduced consumer spending. We also note that applicable U.S. law does not

¹⁷ Federal Reserve Bank of New York, Quarterly Report on Household Debt and Credit, at 7 (November 2014), *available at*: http://www.newyorkfed.org/householdcredit/2014-q3/data/pdf/HHDC_2014Q3.pdf.

¹⁸ The Board of Governors of the Federal Reserve System's Senior Loan Officer Opinion Surveys on Bank Lending Practices during 2008 and 2009 consistently showed that banking organizations took steps to manage their outstanding exposures by lowering available credit limits for credit card accounts. *See, e.g.*, Board of Governors of the Federal Reserve System, The October 2008 Senior Loan Officer Opinion Survey on Bank Lending Practices, Table 1, Question 21, *available at*: <http://www.federalreserve.gov/BoardDocs/snloansurvey/200811/table1.htm>; Board of Governors of the Federal Reserve System, The January 2009 Senior Loan Officer Opinion Survey on Bank Lending Practices, Table 1, Question 21, *available at*: <http://www.federalreserve.gov/BoardDocs/snloansurvey/200902/table1.htm>. Likewise, a 2013 report by the Consumer Financial Protection Bureau indicated that, during the financial crisis "in an attempt to protect against further deterioration in credit performance, credit card issuers sought to reduce their exposure by closing accounts, decreasing unused credit lines, and tightening the criteria for granting new credit or for increasing lines on existing accounts." CARD Act Report, Consumer Financial Protection Bureau (Oct. 1, 2013) p 16, *available at*: http://files.consumerfinance.gov/f/201309_cfpb_card-act-report.pdf.

prohibit a credit card issuer from reducing or canceling a customer's credit line without prior notice.¹⁹

Additionally, applying a CCF of 10 percent on unconditionally cancellable commitments leads to a risk weighting methodology that is inconsistent with the actual level of risk across different accounts. A stated principle of the Credit Risk Proposal is that "capital charges from the standardised approach should reflect to a reasonable extent the risk of the exposures and provide the correct incentives for banks, considering the overall policy objectives."²⁰ Under the Credit Risk Proposal, balances on low-utilization, low-loss accounts may end up with higher effective capital charges than high-utilization, high-risk accounts, creating a conflict between the proposed CCF and the underlying risk.

Finally, we consider exposures related to credit card lending to be sufficiently different from other types of unconditionally cancellable commitments that such exposures might merit separate consideration and treatment. As an alternative proposal, we recommend that undrawn credit card lines be excluded from the category of unconditionally cancellable commitments subject to the increased CCF proposed in the Credit Risk Proposal. A banking organization's exposure related to open credit card lines should continue to be subject to the currently applicable CCF.

2. Conditionally Cancellable Commitments

The Basel Committee has not provided any evidence in the context of the Credit Risk Proposal that its choice of a 75 percent CCF for conditionally cancellable commitments produces the most (or even an) accurate and realistic measure of exposure. Any recalibration of the CCF associated with commitments should be aligned with banking organizations' actual experience as reflected in a comprehensive study that analyzes the true outflow risk associated with these commitments. Prior to the completion of such empirical analysis, the current 20 and 50 percent CCFs should be retained in their present form in the absence of evidence to the contrary. Finally, we believe that maturity period is a relevant credit risk consideration when assigning CCFs for off-balance sheet commitments.

F. Multilateral Development Banks

The Credit Risk Proposal would apply a zero percent risk weight for multilateral development banks "which comply with strict eligibility criteria," and provides that the Basel Committee would maintain a list of such multilateral development banks. We generally support the application of a zero percent risk weight for multilateral development exposures, but request that any list of applicable multilateral development banks be published to avoid confusion and inconsistency.

¹⁹ In the event that a creditor takes an adverse action on an existing account, such as reducing or, in some cases canceling a credit line, the Equal Credit Opportunity Act and implementing regulations require that the creditor send written notice of the action to the applicant within 30 days after taking such action.

²⁰ Credit Risk Proposal at 5.

III. Proposals on Credit Risk Mitigation

The Credit Risk Proposal would substantially modify the credit risk mitigation framework for exposures risk-weighted under the Standardized Approach. Among other changes, the Credit Risk Proposal would: (1) exclude all valuation approaches that rely on internal estimates or models to set capital charges thereby requiring banking organizations to use standard collateral haircuts; and (2) modify the universe of “eligible financial collateral.” We support a robust credit risk mitigation framework that recognizes the credit risk mitigation benefits of financial collateral. However, we are concerned that certain of the modifications in the Credit Risk Proposal would not sufficiently recognize the value of many credit risk mitigation practices of banking organizations and would unduly narrow the universe of “eligible financial collateral” in a manner that is contrary to established and considered market practice.

A. Securities Financing Transactions

Under the current Standardized Approach, a bank can measure the credit risk associated with SFTs using value at risk models or an internal models method to reflect the price volatility of the exposure and the collateral for such transaction. To reduce the reliance on internal models and estimates, the Credit Risk Proposal would eliminate both of these approaches and require banking organizations to treat SFTs under either the “simple” or an amended version of the haircut-based “comprehensive” approach, with highly conservative assumptions. As currently proposed, exposures to SFTs under the comprehensive approach would equal the difference between: (i) the value of the securities lent, plus a risk-insensitive volatility factor; and (ii) the value of the collateral received, less a risk-insensitive volatility factor. We believe that either approach would greatly overstate the risk associated with SFTs and recommend that the Basel Committee consider alternatives to this approach.²¹ Below, we set forth three possible alternative frameworks that we believe better reflect the actual economic risks of these transactions and help resolve some of the principal methodological limitations in the Credit Risk Proposal’s comprehensive approach.

The credit risk mitigation framework in the Credit Risk Proposal is based on a series of collateral haircuts that are set at levels far higher than the haircuts demanded by the market for SFTs even during periods of market distress, particularly for equity securities. The comprehensive approach also suffers from a number of methodological limitations that lead to a significant overstatement of risk, and therefore the maximum possible loss that a banking institution could incur. As an example, the comprehensive approach does not recognize the benefit of diversification within the lending and collateral pools. Similarly, the comprehensive approach does not account for the correlation that exists between various loan-to-collateral pairs, assuming for every counterparty and for every trade—that (i) each security posted as

²¹ As noted above, the regulatory authorities in the United States are considering imposing a number of capital and liquidity penalties for SFTs, such as the proposed short-term wholesale funding framework in the capital surcharges for global systemically important banks. See, Board of Governors of the Federal Reserve System, Risk-Based Capital Guidelines – Implementation of Capital Requirements for Global Systemically Important Bank Holding Companies, 79 Fed. Reg. 75,473 (December 18, 2014). We believe that any proposed treatment of SFTs should be analyzed holistically in the context of other proposals so that the capital treatment of such transactions is commensurate with their underlying risk.

collateral increases in value; (ii) each security received as collateral decreases in value; and (iii) the impact of foreign exchange movements is always negative. These limitations are compounded by the fact that the comprehensive approach provides very limited opportunity for netting, meaning that the larger the portfolio of trades with a single counterparty, the greater the overstatement of credit risk exposure.

Our concerns with the comprehensive approach are similar in nature to those with the current exposure method, which is used to calculate counterparty credit risk for derivative transactions. The current exposure method similarly did not appropriately account for collateral or portfolio diversification effects, which prompted the Basel Committee to develop the more risk sensitive standardized approach to counterparty credit risk (the “**SA CCR**”), the recently adopted methodology for measuring the exposure of counterparty credit risk for certain derivative transactions.²² We believe the Basel Committee should do the same for SFTs.

The impact of the proposed revisions to the credit risk mitigation framework could result in reduced capacity at banking organizations for securities lending activities. This would have substantial impact on securities lenders, such as retirement plans and mutual funds, which rely on bank intermediaries to generate low-risk incremental returns on their investment portfolios, thus reducing liquidity within the securities markets and shifting activities toward the shadow banking sector. This market may already be experiencing stress and reduced liquidity because of other regulatory initiatives. As noted in a recent speech by Dame Clara Furse, external member of the Financial Policy Committee of the Bank of England, regulatory capital and liquidity initiatives may be forcing traditional market participants out of the market, eliminating the essential services provided to companies and investors.²³

In light of these concerns, we suggest the following possible alternatives, which we believe far more accurately measure the risk associated with SFTs. As further information becomes available both as part of our own data collection efforts and analysis, and in response to the results of the QIS, we look forward to discussing the potential calibrations for each of these proposed approaches with the Basel Committee.

1. Revisions to Comprehensive Methodology

Our first alternative is a modification to the comprehensive approach that provides for additional risk sensitivity by calculating exposure at a netting set level and adjusting

²² Basel Committee, The Standardised Approach for Measuring Counterparty Credit Risk (revised March 2014), *available at*: <http://www.bis.org/publ/bcbs279.pdf>.

²³ Dame Clara Furse, External Member, Financial Policy Committee, Bank of England, Liquidity Matters, at 4 (Feb. 11, 2015), *available at*: <http://www.bankofengland.co.uk/publications/Documents/speeches/2015/speech796.pdf>. *See also*, Fitch Ratings, Press Release, “New Basel Market Risk Rules May Reduce Trading Liquidity” (Oct. 31, 2014), *available at*: https://www.fitchratings.com/gws/en/fitchwire/fitchwirearticle/New-Basel-Market?pr_id=912494 (“New Basel market risk rule proposals may reduce trading liquidity further if it results in banks cutting inventory further, Fitch Ratings says. Large European banks have already been reducing their portfolios since the introduction of tougher market risk capital requirements under Basel 2.5 in 2011.”).

the proposed haircuts for loan and collateral pairs to reflect stressed correlations at the 99th percentile for each collateral pair. This approach would eliminate the use of internal models or calculations, and would also provide market transparency and comparability in all jurisdictions by replacing the current linear haircut table with a multi-dimensional table that would account for correlations among cash and securities posted and received with the same counterparty. The haircuts would be based on historical correlation of the various types of securities, based on stressed conditions, which has the benefit of taking into account “right-way” and “wrong-way” risk (*e.g.*, the correlation between cash lent and government securities borrowed will be different from that of equity securities borrowed against equity securities lent). Correlation-based haircuts and the calculation of exposure and haircuts at a netting set level would, unlike the proposed comprehensive approach, recognize that in a diverse loan and collateral portfolio, it will never be the case that the values of all securities borrowed and lent move against a bank at the same time. Moreover, this (and all of our proposed alternatives) would align capital and risk management incentives, as portfolio diversity is a key component of risk mitigation. Finally, a revised, multi-dimensional haircut table would provide for greater risk sensitivity without detracting from the simplicity and transparency of the proposed comprehensive approach.

2. Modification of Standardized Approach CCR

Our second alternative is a modification of the SA CCR. Because many SFTs and derivative transactions are economically identical, the SA CCR could be easily adapted to cover SFTs. This approach would involve the mapping of securities loan and collateral types to existing SA-CCR assets classes—specifically, equity securities to equity derivatives, fixed income securities to interest rate and credit derivatives, and currency mismatch to foreign exchange derivatives. Under this approach, securities loans would be treated as a short derivatives exposure and collateral would be treated as a long derivatives exposure.

Among the benefits of this method are its heightened risk-sensitivity and calibration on the basis of an approach for the measurement of credit risk that has already been vetted and approved by the Basel Committee. Furthermore, and as noted above, this approach has the advantage of ensuring consistency in the treatment of SFTs with economically equivalent derivatives, thereby averting the kind of arbitrage that would otherwise result from the presence of starkly different methodologies within the Basel Committee’s overall credit risk mitigation framework. This approach would further the Credit Risk Proposal’s stated goal of reducing the reliance on internal models while more accurately approach the economic realities of SFTs.

3. Regulatory Input Method

Our third alternative is an exposure calculation based on supervisory assessments of collateral value, market volatility, and correlation, similar to the methods some international authorities have adopted for their stress testing processes. More specifically, this method would involve the use of a prescribed formula populated by a series of data elements provided by the supervisory community based on observable data that is relevant to SFTs. This includes the volatility of the lent security, the volatility of the collateral received, and the stressed correlation that exists between the lent security and the offsetting collateral calibrated to a 99th percent confidence interval. Under this method, the only data that a banking institution would independently provide are the value of lent securities and collateral received,

thereby ensuring exposure calculations which are easily comparable across banks. Among the benefits of this approach is its inherent flexibility, including the capacity for the supervisory community to adjust confidence levels and the ability to update parameters based upon changing market conditions. This approach can also be enhanced to reflect differences in exposures resulting from “right-way” vs. “wrong-way” risk, and would not require any internal modeling or estimates by banking organizations.

B. Securitization Exposures

The proposed credit risk mitigation framework would not treat guarantees from corporate guarantors as an eligible credit risk mitigant for purposes of securitization exposures. Corporate guarantees offer real mitigation benefits and should be recognized as an eligible credit risk mitigant in this context.

The Credit Risk Proposal raises the concern that banking organizations can arbitrage securitization exposures through the use of corporate guarantees. This concern can be addressed through additional restrictions on the types of exposures that can be treated as eligible guarantees. More particularly, the U.S. Standardized Approach incorporates a number of qualifying criteria prior to the recognition of a guarantee for credit risk mitigation, such as a requirement that the protection provider make a payment to the beneficiary in a timely manner without first requiring legal action and a requirement that the cost of the protection is not increased in response to a deterioration in the credit quality of the reference exposure.²⁴ Adopting these types of restrictions should address the Basel Committee’s concerns relating to corporate guarantees for securitization exposures.

We also note that the Basel Committee has recently finalized its securitization exposure framework in December 2014, which covered potential changes to the credit risk mitigation framework for securitization exposures.²⁵ Given that this comprehensive securitization framework was recently finalized, any further changes should be encompassed within the securitization framework as part of any future amendments to the framework.

C. Credit Default Swaps as Eligible Financial Collateral

The Credit Risk Proposal would no longer recognize credit derivatives that do not specify a restructuring as a credit event as “eligible financial collateral.” The Credit Risk Proposal’s exclusion of credit derivatives without a restructuring clause would have a particularly negative and unwarranted impact in the United States where market practice driven primarily by the application of U.S. insolvency law under the U.S. Bankruptcy Code has not required such clauses. If implemented, it would require a significant change to the market for credit derivatives in the United States, and is not necessary because true credit events will be captured by the bankruptcy and failure to pay clauses of credit derivative contracts. In addition, to include restructuring clauses would only serve to increase operational and systemic risk in the near term as banking organizations and central clearing counterparties will need to manage the basis risk from legacy credit derivatives without the restructuring provision.

²⁴ 12 CFR 217.2.

²⁵ Basel committee, Basel III Document: Revisions to the Securitisation Framework (December 11, 2014), *available at*: <http://www.bis.org/bcbs/publ/d303.pdf>.

The standard form New York law credit derivative confirmations do not require restructuring clauses, but permit them if requested by the parties.²⁶ Rather, these credit derivatives and other commercial agreements rely on “failure to pay” and “bankruptcy”²⁷ clauses that are intended to capture the most applicable credit events in the United States. The purpose of debt restructuring clauses is to cover circumstances where a company that is experiencing a credit event that would otherwise qualify as an insolvency or a bankruptcy avoids the bankruptcy process by negotiating a restructuring of the company’s operations or debt. In contrast to many other jurisdictions, debt restructurings, where a company is truly experiencing a credit event that would otherwise trigger bankruptcy, are uncommon in the United States. Rather, most restructurings occur in the context of Chapter 11 of the U.S. Bankruptcy Code,²⁸ which, unlike the formal insolvency laws of many other jurisdictions which typically involve liquidation proceedings, specifically creates a court-administered reorganization process, and therefore fall within the bankruptcy clause for such agreements. Because of this, many commercial agreements in the United States, including most credit derivatives, do not contain restructuring clauses, and instead rely on the bankruptcy clause.

Moreover, in the United States, bond indentures typically require 100 percent (or some other high majority) of holders to consent to changed terms that substantively affect the economic value of the bonds. Thus, a non-bankruptcy debt restructuring (that is a restructuring outside of the context of bankruptcy) is almost impossible if the consent of all, or nearly all, bondholders is required. If a bondholder refuses to consent to the restructuring, the borrower will be legally required to repay the bond, default (which would trigger a credit derivative’s “failure to pay clause”), or declare bankruptcy to restructure the debt (which would trigger a credit derivative’s “bankruptcy clause”). Furthermore, because many bonds cannot effectively be restructured without the bondholder’s consent, bondholders need not purchase credit derivatives that cover a restructuring. The same analysis would be true for syndicated loans in the United States, which also typically require the consent of all lenders prior to the restructuring of any substantive economic terms.

Because credit derivatives are becoming more and more centrally cleared (as required by Title VII of the Dodd-Frank Act), these derivatives have, in large part, become commoditized without restructuring clauses. The requirement for credit derivatives with a restructuring clause would require a significant market change or would force banking organizations to enter into an increased number of bilateral over-the-counter derivatives for credit risk mitigation purposes.

Furthermore, in certain lending structures, restructuring credit events are simply less relevant, and potentially completely irrelevant. For example, credit derivatives on asset-backed securities facilities generally do not include restructuring credit events because restructuring is typically not a potential outcome in many asset-backed securities structures.

²⁶ International Swaps and Derivatives Association, Inc., 2003 Master Credit Derivatives Confirmation Agreement, sections 3 (2003).

²⁷ International Swaps and Derivatives Association, Inc., 2014 ISDA Credit Derivatives Definitions, sections 4.2, 4.5 (2014).

²⁸ 11 U.S.C. Chapter 11.

Accordingly, credit derivatives markets providing credit support to asset backed securities facilities generally do not specify restructuring as a credit event.

U.S. organizations rely on credit derivatives as an effective risk mitigation tool, and the exclusion of a restructuring clause has not prevented U.S. credit derivatives from functioning as effective hedges. Thus, we believe that the Basel Committee should not require that credit derivatives contain a restructuring clause to qualify as “eligible financial collateral.” At a minimum, we believe that the Basel Committee should consider permitting national authorities to take market practices into account when developing standards for determining when credit derivatives qualify as eligible financial collateral.

In addition, the Standardized Approach currently applies a 40 percent haircut for credit derivatives that do not specify a restructuring as a credit event.²⁹ This haircut grossly overstates any haircut that might be demanded by the market for credit derivatives without such clauses. As noted above, in the United States, a restructuring that reflects a true credit event outside of a bankruptcy proceeding is relatively rare. Therefore, if the Basel Committee retains credit derivatives without restructuring clauses as eligible financial collateral, when the Basel Committee considers the calibration of credit risk mitigation framework, we would recommend that the Basel Committee remove this haircut entirely.

D. Eligible Financial Collateral and Haircuts

The revised credit risk mitigation framework may deepen, rather than reduce, the reliance on external credit ratings under the Standardized Approach. Banking organizations using the current Standardized Approach may use internal estimates or models of credit risk mitigation for certain exposures backed by eligible financial collateral. To reduce the reliance on internal models and estimates, the Credit Risk Proposal would remove banking organizations’ ability to use models or internal estimates for determining haircuts on eligible financial collateral. However, the Credit Risk Proposal would instead solely rely on an external credit ratings based approach. For example, under both the revised simple and comprehensive approaches contemplated by the Credit Risk Proposal, only collateral that meets certain minimum credit ratings would be eligible financial collateral. Likewise, the comprehensive approach would apply a haircut that is, in part, measured by the credit rating of the issuer of the collateral. As a potential alternative to the usage of external credit ratings, the Basel Committee also proposed to rely on an investment grade standard for determining eligible financial collateral and an alternative haircut method for the comprehensive approach, using the residual maturity of the exposure and the type of entity.³⁰

We support the Basel Committee’s proposal to adopt the investment grade methodology in this context (as well as for corporate exposures as discussed above) in a manner

²⁹ Basel II, ¶¶ 191, 192.

³⁰ The Credit Risk Proposal would define investment grade “as a security of which the issuer has an adequate capacity to meet its financial commitments under the security for the projected life of the asset or exposure; meaning that: (i) the risk of default by the obligor is low and (ii) the full and timely repayment of principal and interest is expected.”

that does not rely on external credit ratings.³¹ Likewise, for the comprehensive approach, we also support the Credit Risk Proposal's proposed alternative haircut method that relies on the residual maturity of the exposure and the type of entity rather than solely upon external credit ratings. As noted above, due to legal restrictions in the United States, reliance on external credit ratings for purposes of capital related or any other regulation is prohibited by statute.³² This would enhance harmonization of capital requirements across jurisdictions.

E. Core Market Participant Exemption

The Credit Risk Proposal invites comments on the current exemption for "core market participants" from the Standardized Approach's 20 percent risk weight floor after applying the credit risk mitigation framework. The Standardized Approach permits this exemption at the discretion of national supervisors, as an exemption from the risk-weight floor for transactions with "core market participants."³³

We support the elimination of the core market participant exemption from the 20 percent risk weight floor because the exemption has the potential for reducing capital requirements with respect to SFTs for those jurisdictions that have adopted the exemption without any correlation to the underlying economic risk posed by the institution. The exemption from this floor for some market participants—but not for others—is, at minimum, inconsistent with the Basel Committee's goal of reducing interconnectivity among financial institutions by providing some organizations preferential capital treatment for increasing interconnectivity with other financial institutions.³⁴ This exemption is also inconsistent with the Credit Risk Proposal's core stated objective of the Standardized Approach being "capable of explaining risk across jurisdictions." Simply put, the core market participant exemption for some jurisdictions is not justified *across* jurisdictions and would only serve to increase competitive inequalities *vis-a-vis* jurisdictions which properly choose not to implement the exemption.

IV. National Discretion

As noted above, all U.S. banking organizations are required to calculate their risk-based capital ratios under the U.S. Standardized Approach, including as a statutory floor for organizations that calculate their risk-based capital ratios under the U.S. Advanced Approach.³⁵ In addition, legislation in the United States also prohibits any regulations, including capital rules,

³¹ This would be consistent with the concept of investment grade found in the U.S. Standardized Approach. See, 12 CFR 217.2.

³² See, Section 939A, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, H.R. 4173.

³³ Basel II, ¶¶ 66-68.

³⁴ For example, the Basel Committee has increased capital requirements for interconnected banking organizations in the capital surcharges for global systemically important banks, and has imposed additional liquidity requirements for transactions between financial institutions under the liquidity coverage ratio.

³⁵ 12 U.S.C. § 5371; 12 CFR 3.10(c); 217.10(c); 324.10(c).

from referencing or relying on external credit ratios.³⁶ In its recent adoption of capital standards that implement the Basel III capital accords and the U.S. Standardized Approach, the U.S. Federal banking agencies considered many of the issues discussed in the Credit Risk Proposal, including providing for additional risk-sensitivity for corporate exposures without relying on credit ratings, and ultimately rejected various alternatives in favor of a standard that provides for higher overall capital requirements and somewhat reduced risk sensitivity. We believe that, in light of the domestic legal restrictions discussed above, the approach adopted by the U.S. Federal banking agencies should be permitted under any revised Standardized Approach.³⁷

We are concerned that, should the Basel Committee seek to eliminate most instances of national discretion in calibrating and designing the Standardized Approach, these binding U.S. legal restrictions would nevertheless remain in place. Thus, without appropriate national discretion in this area, the U.S. Federal banking agencies would be faced with the unfortunate choice of having to apply both the legislatively required minimum U.S. Standardized Approach and some version of the revised Basel Standardized Approach to at least some subset of U.S. banking organizations. This would have the effect of increasing material deviations for the global standard, causing further disharmonization of capital standards, decreasing transparency and significantly increasing complexity by creating potentially three (or four, when taking into account the U.S. capital planning and stress testing requirements)³⁸ different minimums capital regimes at the same time for such U.S. banking organizations. Although we generally support the goal of globally consistent capital requirements and also support increasing risk-sensitivity for certain aspects of the Standardized Approach, we believe that any revised Standardized Approach should retain elements of national discretion insofar as they are designed to address domestic legal restrictions or market practice. Such elements of national discretion should be permitted so long as they provide for capital requirements that are, in the aggregate, as, or more, stringent than would be required under the revised framework. The requirement that national discretion would be permitted where the national framework is as robust in the aggregate as the Basel Standardized Approach would also help ensure that no competitive inequalities arise across jurisdictions. The Basel Committee can and should use its successful peer-review process to ensure that national regulators use this discretion appropriately.

V. Capital Floor Proposal

To improve the comparability of capital measurements across firms and across jurisdictions, the Basel Committee simultaneously issued the Capital Floor Proposal. The Capital Floor Proposal seeks comment on the level of aggregation or granularity of comparison between the Standardized Approach and the Advanced Approach. Specifically, the Basel Committee sought comment on whether: (1) the total risk-weighted assets calculation under the Standardized Approach should comprise a floor to the total risk-weighted assets calculation

³⁶ See, Section 939A, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, H.R. 4173.

³⁷ We further note that, given the recent effective date of the U.S. Standardized Approach, January 1, 2015 for most banking organizations, further changes to the framework should not be contemplated until a multi-year review of the effect of the new rules is complete.

³⁸ See, 12 U.S.C. § 5365(i); 12 CFR 225.8; 252 subparts E and F.

under the Advanced Approach (an “**Aggregate Floor**”); (2) each risk category component (*e.g.*, credit risk, market risk, and operational risk) of the Standardized Approach should serve as a separate floor for each risk category of the Advanced Approach (a “**Risk-Category Based Floor**”); or (3) an exposure-by-exposure measurement where each Standardized Approach exposure class will serve as a floor to the Advanced Approach calculations (an “**Exposure-Based Floor**”).

As noted by the Basel Committee, any revisions to the Standardized Approach will have a direct impact on the structure, and complexity, of any capital floor as finalized. Furthermore, most aspects of the Standardized Approach and Advanced Approach risk-weighting frameworks are currently under review, if not undergoing substantial revision. While we assume this is why the Capital Floor Proposal postpones the topic of calibration, it is difficult to assess the potential impact of a revised floor. Accordingly, it would be more appropriate for the Basel Committee to wait to finalize its approach to floors until the components of the capital framework have been finalized and their impacts properly studied.

We are concerned that the choice of a capital floor, such as the Risk-Category Based Floor or the Exposure-Based Floor, that requires a banking organization to undergo multiple calculations will introduce significant operational complexity without any significant capital comparability benefits. Moreover, the more complex and multitudinous the floor calculations, the more difficult it will be for market participants to meaningfully weigh and effectively compare the capital levels of various banking entities in different jurisdictions—or even in the same jurisdiction. We therefore believe that the choice of an Aggregate Floor approach provides a more proper and transparent basis for determining the capital comparability of various institutions, as well as provides an appropriate check against any material discrepancies in an institution’s internal models.³⁹ Likewise, the choice of an Aggregate Floor would introduce the least amount of complexity, consistent with the Basel Committee’s recent considerations as to whether the “the capital framework has become too complex.”⁴⁰

Finally, we agree with the Basel Committee that the choice of the Standardized Approach as a floor should be the Standardized Approach that is implemented in the jurisdiction of the bank. We also believe that a scaling factor should be applied so that the Standardized Approach floor is a portion (*e.g.*, 80 or 90 percent) of the risk-based capital calculations under the Standardized Approach. The application of a scaling factor will ensure that the Standardized Approach acts as a proper backstop to the Advanced Approach rather than as a binding constraint. If no factor is applied, we are concerned that the Standardized Approach would effectively become the binding capital ratios, making the internal model preparations and validations required to comply with the Advanced Approach less meaningful.

³⁹ We note that legal restrictions in the United States mandate the usage of the U.S. Standardized Approach as an “aggregate” capital floor. Thus, the imposition of any other type of capital floor could introduce significant additional complexity into the United States because both floors may need to be calculated and met.

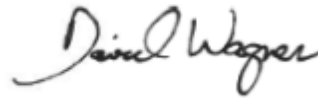
⁴⁰ Basel Committee, Discussion Paper: The Regulatory Framework, Balancing Risk Sensitivity, Simplicity, and Comparability at ¶ 79 (July 2013), *available at*: <http://www.bis.org/publ/bcbs258.htm>.

* * *

The Clearing House appreciates the opportunity to comment on the Proposals. We would be pleased for the opportunity to meet with representatives of the Basel Committee to discuss these comments and the topics of the Standardized Approach and the Capital Floors Proposal more broadly if the Basel Committee believes it would be helpful.

If the Basel Committee would like additional information regarding these comments, please contact me at (212) 613-9883 (email: david.wagner@theclearinghouse.org).

Respectfully submitted.



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