POSITION PAPER

WSBI-ESBG common response to the Basel Committee consultation on the revision to the Standardised Approach for credit risk

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1. General comments

First of all, WSBI-ESBG welcomes this opportunity to share our views on the consultation on the revision of the Basel Committee framework to the standardised approach for credit risk.

The present consultation paper has to be seen in the context of the extensive revision of the various elements of the Basel framework which are based in particular on the knowledge gained from the financial market crisis. We can, therefore, understand that the Basel Committee has identified a need to also change the Standardised Approach for Credit Risk. The goal of designing the new framework in such a way that it, on the one hand, will be more risk-sensitive than the former one, but, on the other, will continue to be simple to apply is basically welcome. The aspect of simplicity of the new framework is to be emphasised particularly to ensure that ultimately the standardised approach will continue to be applicable with reasonable expenditure by the large number of smaller banks.

What is of particular importance from our point of view is the Committee's working premise to adjust the framework only in those cases where this is sufficiently justified, i.e. necessary. The effort to eliminate to a great extent the use of external ratings for the calculation of the capital requirements also is to be judged against that background. This seems to be characterised by the claim of politics under the impression of the financial and sovereign debt crisis to reduce the dependency on external ratings in the set of rules. However, a complete ban of external ratings was in our opinion not the subject of negotiation.

Generally speaking, we have serious doubts as to whether this new approach based on two simple parameters will be more risk sensitive than the external ratings. It must be kept in mind that the original idea behind was to reduce the role of the external ratings, not to completely eliminate them, even for those exposures that did not show problems throughout the recent crisis.

Indeed, an essential advantage of external ratings is the fact that they consistently take account of certain forward-looking components. Consequently, ratings reflect risk exposure much more precisely. Therefore, we are in favour of preserving external ratings under the new approach. Where an external rating is not available or a rating agency is not named, determination of the risk weight should, for bank exposures, be based on the country of incorporation method and, for corporate exposures, be obtained on the basis of new and easy-to-determine parameters. Furthermore, it has to be taken into account the regulatory measures carried out in order to improve the regulatory framework of credit rating agencies, at least in the EU.

The main problem with the approach taken by the Committee is the intention to apply one model calibrated in the same way in all jurisdictions all over the world. We consider that it is not appropriate to globally define a detailed standardised approach for credit risk to be used by tens of thousands of banks in multiple and heterogeneous jurisdictions. The conditions of these banks - in the form of, for example legal, cultural and market conditions - are too different for a fully harmonised, standardised approach to work. Moreover, we deem that the new detailed approach may provide a false sense of accurateness which can be quite misleading since the level of actual risk associated with a certain exposure can vary significantly between countries depending on which jurisdiction the borrower is domiciled and the collateral is placed.

Furthermore, we consider that it is essential that the new approach gives the right incentives and does not hamper some markets by imposing capital requirements which are inadequate because they do not take national market- and sector-specific factors into account.

Therefore, if the Basel Committee intends to maintain the proposed two factor models the calibration of risk weights must be performed at national level, taking the particularities of local jurisdictions into account. Otherwise, the actual risks associated with a particular risk weight will not be comparable between jurisdictions. We believe that the approach to be taken by the Basel Committee should be a global standard with local calibration as it was highlighted by several stakeholders during the hearing held in Frankfurt with the Task Force on Standardised Approach on 24 February 2015.

The drawbacks of these shortcomings will be further accentuated by the Committee's intention to let the standardised approach also serve as a global benchmark for the recently proposed capital floors and for disclosure requirements regarding the risk weights of IRB-banks operating in several jurisdictions and raising funds on the international capital markets. Furthermore, the impact would be even greater taking into account that some other reforms have not yet been fully implemented, such as the leverage ratio, TLAC, and Pillar 3 disclosures. We would like the Basel Committee to take into account the fact that different pieces of banking rules recently been put forward have significantly increased capital requirements and costs for banks. Furthermore, the Committee should also consider that after the whole package of reforms passed the situation cannot be compared in terms of risks of the banking sector and buffers and safeguards already in place in the system.

We would also like to show our concerns on the likely costs for banks in terms of increased capital requirements that this revision will have. We appreciate the intention of the Committee that the revision will not lead to increasing overall capital requirements under the standardised approach. It is however, our impression that the new proposals, as currently calibrated, will lead to increasing capital requirements in some jurisdictions and in particular for some exposure categories or parts of exposure categories such as banks, SMEs and real estate. This is likely to hamper the flow of credit to the real economy and to increase the margins the banks must require in order to cover their costs.

Also, the lack of information is very penalised in terms of capital requirements since if some risk drivers proposed by the Committee are not available, it will be applicable a risk weight of 300%. This would be as demanding as having, for instance in the bank portfolio, an exposure on a bank with a CET1 < 4.5% (insolvent); and more than doubling the 2nd worst case. We understand this as an incentive to obtain that information, but it is not always feasible to obtain it; a lower penalty instead of that 300% would be more appropriate. Related to the data availability problem, selecting counterparty banks abroad on the basis of their CET1 position doesn't seem to be the best way to give our customers the best service. This is particularly true in those jurisdictions where Basel III is not applicable or the data is not public (unlisted banks).

We also notice that the Basel Committee does not provide insight into what its plans are with regards to sovereign and PSE exposure. Missing this essential information means that it is difficult for us to estimate the full impact of the revision and take position on the relevance of the proposed changes.

Moreover, it is important to consider the impact of this proposal in terms of resources for smaller banks. The proposal suggests that risk drivers based on individual counterparty information shall be used to separate counterparties into different risk buckets. Creating systems for measuring, reporting and monitoring these risk drivers will be very resource-demanding for smaller banks. These costs will be less important for a large bank, but for smaller banks they will be substantial and create further competitive disadvantage. For very small banks, it is hard to see that this type of burden is warranted at all. Therefore, we believe that certain exemptions or special treatment should be granted for these smaller banks.

Since the changes are of a fundamental nature, we are grateful that the proposals are to be evaluated by means of a comprehensive impact study (QIS). However, it has to be feared that the QIS conducted in parallel can ultimately just be an initial indication as to the further calibration. On the one hand, we believe that some of the currently selected risk drivers are not suitable indicators. On the other, the data are in principle available at the banks, but not in the reporting systems relevant to the QIS. Moreover, manual acquisition cannot be reasonably effected by the banks given the short time available and the expenditure associated with it.

Finally, we miss information about the timeline for the implementation of the future framework, which we propose to be as long as possible in order to give institutions enough time in order to adapt

2. Responses to questions

Please find below further and detailed responses and some comments on particular items of the consultation put forward by the Basel Committee:

Exposures to Banks

We would like to express some comments on the approach taken for the exposures to banks.

Firstly, the Basel Committee proposal establishes that "A bank exposure would be assigned the highest risk weight of 300% if the relevant information is not published within the frequency required by the Pillar 3 disclosure requirements." In our opinion this treatment penalises the institutions which have the exposition instead of the bank that fail to fulfil the Pillar 3 disclosure requirements. Given that Pillar 3 is usually disclosed annually, during a whole year the institution will see penalised its exposure with that bank. Due to this, the punishment due to not complying with Pillar 3 disclosure requirements should only be applied to the bank that doesn't disclose it with the frequency required. Paragraph 17 of Annex I provides that "a 300% risk weight will also apply in cases where a bank is aware that one of its obligor banks has breached any binding minimum prudential standard to which they are subject by their national supervisor." This requirement is assuming that the obligor bank is going to incur in serious problems, which is difficult to predict for the institution due to the confidentiality of the supervisory process.

In this context, it is necessary to take into account the implications related to the banking group structure, especially regarding the instrumental subsidiaries that are guaranteed by their parent institution. This circumstance, which is usually considered by the credit rating agencies in their assessment, has not been contemplated in the consultation.

Finally, not all the exposures to banks should be treated in the same way, since although the issuer can be the same, issuances can be different and the risk weight should reflect it. For example, an issuance of senior debt should not have the same risk weight as liabilities to institutions with an original maturity of less than seven days, excluding entities that are part of the same group taking into account the bail-in framework.

Q1. What are respondents' views on the selection of the capital adequacy ratio? In particular, is the CET1 ratio superior to the Tier 1 ratio or the Leverage ratio? Do respondents agree that it is necessary to require calculations in accordance with Basel III in order to ensure a consistent implementation?

We would like to express our concerns and question 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. For instance, it includes the country risk.

Furthermore, it should be also considered the fact that since for the time being there does not exist any centralised entity which collects the data relevant to reporting banks' CET1 ratio it is very hard for the banks to manually collect these data. We understand that the lack of a uniform definition and central availability of the risk drivers is an important issue on the proposed framework.

Regarding the introduction of CET1 as an indicator to obtain the risk weight related to institution exposition to banks, we would like to point out the following problems that we have detected:

- The fact that some jurisdictions don't apply the Basel III accord yet should be considered. This can be observed in the Financial Stability Institute[1] (FSI) survey on Basel II, 2.5 and III Implementation published in July 2014 which details the status/plans regarding the implementation of Basel II, 2.5 and III in jurisdictions that are members of neither the Basel Committee nor the EU. Institutions with exposures to banks based on such jurisdictions could have problems to identify their CET1 ratio. This possibility should be taken into account, all the more when the alternative treatment is applying a risk weight of 300%.

- Applying the CET1 ratio to calculate risk weighted assets for exposures to banks, and therefore the final CET1 of the institution, could cause a vicious circle since the CET1 ratio of one institution will be influenced by the CET1 ratio of their counterparties (i.e. if the CET1 ratio of a counterparty falls the institution CET1 will fall too). This could be a source of systemic risk and a cyclical driver.

- Also, we consider that CET1 is not the best driver for measure banks' financial health. For example, a bank with a high level of CET1 can face other problems (related to internal fraud, anti-money laundering issues, etc.) that endanger the continuity of its activities.

- The risk weights table proposed by the BCBS will indirectly force institutions to maintain at least a ratio CET1 of 12%, considerably higher than the 4,5% required by Basel III, even taking into account capital buffers (9,5%). Taking this into account, perhaps the total capital ratio would be a better proxy of the solvency of the company as it is closer to the percentages proposed

We therefore believe that external credit ratings give the most comprehensive information about the inherent risk in bank exposures. External ratings should, by default, continue to be applied where they are available and approved rating agencies have been named. Only where this is not the case should the present country of incorporation method be applied.

There should be more granularity in the left side of the table for bank exposures so that banks with higher CET1 ratios (e.g. CET1 ratios above 14%) should receive a lower risk weights.

[1] Created by the Bank for International Settlements and the Basel Committee on Banking Supervision in 1999 to assist financial sector supervisors around the world in improving and strengthening their financial systems.

Furthermore, we would like to suggest that Covered bonds are also considered as they are not mentioned in the proposal. These bonds have a preferential claim on the asset pool which makes them less risky than other exposures to banks, and the risk weights should take this into account. The specific covered bond legislation fulfils certain strictly defined criteria and the current proposal does not take the provided collateral into account.

Q2. Do respondents believe the net NPA ratio is an effective measure for distinguishing a bank exposure's credit risk? What alternative asset quality measure, if any, should be considered by the Committee?

With regards to non-performing assets we would like to lay out the following considerations:

- The BCBS should set standards for disclosure requirements in this field since non-performing assets are not currently disclosed under Pillar 3.
- The BCBS introduces a conservative measure of 30 days past-due for non-performing investment debt securities and other interest-bearing balances.
- NPA definition should be compatible with non-performing loans and forbearance in the EU (which is not currently the case).
- The word "net" on NPA implicitly introduces provisioning rules in the framework; provisioning rules are also heterogeneous by nature and largely differ from one country to another.

Q3. Do respondents have views on the proposed treatment for short-term interbank claims?

In our opinion, the proposed treatment is quite restrictive and will affect the interbank market. The possibility of rolling over should be maintained, not affecting the reduced ratio proposed. Otherwise, it could crowd out certain institutions from the market that currently can operate in normal conditions, forcing them to appeal to other financial resources (shadow banking). We understand that this is not a goal of this regulation.

Q4. Do respondents have suggestions on how to address these concerns on the treatment of exposures to banks? In particular, do respondents have views on how to treat exposures to banks not subject to Basel III in a consistent and risk-sensitive manner?

We suggest applying the treatment contemplated in the CRR which consists of applying external credit ratings, and only if a credit assessment by a nominated ECAI is not available, assign a risk weight according to the same credit quality step as the exposures to the central government of the jurisdiction in which the institution is incorporated.

<u>Exposures to Corporates</u>

Q5. Do respondents have views on the selection of risk drivers and their definition, in particular as regards leverage and the incorporation of off-balance sheet exposures within the ratio? Would other risk drivers better reflect the credit risk of corporate exposures?
Q6. Do respondents have views on the appropriateness of the proposed treatment, especially with regard to SMEs? And about the more lenient treatment for start-up companies?

As for the banks' exposures we question the proposed framework for corporate exposures, since the counterparty's rating, when available, 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 - capture the risk better than the external ratings system. 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 very different as a risk driver compared to in larger developed economies.

With regards to the selection of drivers for corporate exposures we consider that revenue is not by itself evidence of the probability of the default of a corporate. We assume the Basel Committee's intention is that revenue should be an adequate size indicator for corporates. We do not share this view. According to our understanding total revenue must at least be accompanied by gross assets in order to convey an adequate size ranking since the mix between revenue and total assets differs significantly between industries. For example, real estate companies and other industries holding long-life tangible assets usually have low revenues in comparison to total assets whereas the relationship is the opposite for trading related businesses.

We do not share the view that risk weights for corporates should decrease as the total revenue increases. According to our view, capital requirements should be driven by volatility in loan losses on a portfolio level rather than by the likelihood of losses on individual clients. Banks usually charge customers margins that are high enough to cover 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 mean 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 as the SME portfolio is usually much more granular.

We are also concerned about the cliff effect that will emerge due to the significant difference in risk weights between enterprises belonging to the retail exposure category and low revenue enterprises belonging to the corporate exposure category. We don't believe this difference is motivated from a risk perspective and we think it may harm small enterprises growth and thereby also harm a sound development and recovery of the real economy.

Depending on the business sector of the corporates and their business model, revenues can be low but with a high profitability. In such a case the proposed buckets of risk weights will affect them negatively. Also, the segmentation by revenue will impact negatively the competitiveness of small and medium enterprises (SMEs) and will restrict bank funding to them. It should be taken into account that in several countries the industry structure is characterised by relatively small companies. This does not, however, necessarily mean that these countries' industries are less robust in an international context. With the proposed risk weights these countries' industry would appear more risky than what they actually are. Secondly, when looking at a corporate exposure from a portfolio perspective, larger businesses could actually be more capital-demanding since, even if defaults for such entities are rare, the impact will usually be far more severe than when a small entity belonging to a bank's SME portfolio defaults. Nevertheless, given the lower degree of default for large corporates there should not be in any case an increase in the risk weighting for these companies.

One possible solution is to divide corporate exposure into two categories with different treatment; one category for large companies and one category for SMEs. For large companies, external credit ratings are usually available and will provide a better risk measure than the proposed two-factor model. External credit ratings take into account a number of risk factors and thus provide a more complete picture of the risk in the individual enterprise.

We would also like to propose that the Basel Committee considers whether it could be possible to take credit assessments made by national credit agencies, fulfilling a set of Basel requirements which aim to ensure quality and avoiding conflicts of interest, into account. It would then be possible to significantly increase the number of entities for which there exists a reliable external credit assessment which takes the local environment into account.

We also question whether the proposed division of risk weights for corporate exposures, with no consideration of collateral, provides a reasonable risk measurement. Smaller companies constitute the bulk of SA-banks' corporate portfolio in many countries. Equity in these smaller companies is often underestimated because asset values are seldom valued at fair value. This will make the relation between risk weights based on "accounting leverage" and actual risk quite arbitrary. The use of LTV for corporate loans secured by real estate will thus provide a better measure of risk, and it will reduce the problems associated with the measurement of "leverage" for smaller enterprises.

There should be more granularity in the risk measurement of corporate exposures, with lower risk weights for companies with the lowest risk. This would better reflect the inherent risk in the exposures.

With regards to the more lenient treatment for start-up companies, we welcome it, but it seems not to be enough to promote new entrepreneurship in the current context.

Leverage is also a driver dependent of the business sector and it has to be taken into account for the application of risk weights in order to not prejudice activity sectors characterised by high levels of leverage. Moreover, as paragraph 24 of Annex 1 states, components of leverage are determined by the accounting standards of jurisdictions, but it has to be taken into account that accounting differences among jurisdictions may cause valuation divergences as well, i.e. the relationship between a firm's "accounting leverage" and, from an economic point of view, the true leverage will vary between jurisdictions depending on how the local GAAP is designed. The relationship will also become stochastic within jurisdictions if the local GAAP prescribes that assets should be valued at historic costs less accumulated depreciations, since in this case the point in time when an asset was acquired will have a significant impact on its "accounting value" and the relationship between that value and the asset's market value.

A combination of operational leverage and financial leverage could be a solution. Another solution is to adapt leverage to the type of industry and only use it on enterprises reporting assets at "amortised cost" when the turnover of its assets is high.

<u>Further comment on point 2.3. of the consultative document - Subordinated debt, equity and other capital instruments</u>

In the proposal there is currently no difference in the risk weights between subordinated loan capital and AT1 hybrid instruments (e.g. perpetual subordinated loan capital securities) in the proposal. Hybrid instruments are however more risky than subordinated loan capital as these have junior priority compared to latter. This should be reflected in the risk weights. Individual shares are given the same risk weights as equity funds, however equity funds are considered less risky because of the diversification effect.

All these issues may be arranged through a simple and well-calibrated system of add-ons which should start from a simple senior-debt position.

There is a large difference in risk weights between listed and unlisted shares in the proposal. This will impose huge savings by IPO. A risk weight of 300-400% on equities as suggested in the proposal may impede restructuring as the banks will be reluctant to convert debt into equity.

Q8. Do respondents agree that introducing the specialised lending category enhances the risk sensitivity of the standardised approach and its alignment with IRB?

The proposed treatment assigns a minimum risk weight of 120% or 150% depending on the subcategories of specialised lending. Those high risk weights will penalise this kind of lending which is necessary for economic development, especially for project finance or land acquisition, development and construction.

<u>Exposures to Retail/SME</u>

Q9. Can respondents suggest, and provide evidence on, how to increase the risk sensitivity of the regulatory retail exposures treatment, either by differentiating certain product subcategories for which a specific risk weight may be appropriate; or by suggesting simple risk drivers that could be used to assess the risk of all retail exposures?

In the area of the retail exposures we do not see any fundamental need for changes to the existing regulations. According to sub-section 34, the "orientation criterion" is restricted to small enterprises. We suggest extending the scope of application to medium-sized enterprises for both language and contents. This is actual practice in Europe. According to this, an enterprise with sales of ≤ EUR 50 m or a balance sheet total of ≤ EUR43 m is an SME. Risk sensitivity might be achieved by further subdividing the retail exposure class into SME/commercial customers (risk weight 60%) and natural person(s) (risk weight 75%).

In addition, a risk weight of 50% might be provided for secured motor vehicle financing and leasing. This is a rather conservative value which might be empirically proven in the future. In the past, the losses incurred in the secured motor vehicle financial leasing and lending business were relatively low throughout. This is in particular true for the car financing and leasing business with private customers. Willingness to pay is very high in this area, as the vehicle is urgently needed to keep the customers mobile. A risk weight of 75% substantially overemphasises the actual risk.

If need be, one might additionally consider another differentiation by certain product categories which, however, would considerably increase the complexity in this very much standardised and highly diversified volume business. Therefore, we believe the introduction of additional product criteria is questionable. A worldwide definition of products and their handling in the equity capital securitisation process seems impossible and will lead to arbitrariness and unnecessary expenditure. National peculiarities might be taken into account.

The introduction of additional risk drivers contemplated by the Committee appears difficult. While, e.g., the income available for credit repayment definitely is a criterion for a debtor's creditworthiness, the inclusion of a debt service coverage (DSC) ratio into the risk weighting for the capital requirements is not expedient. In the paper, the Basel Committee basically emphasises that the banks' individual internal approaches shall not be applied in the new framework. However, there is no globally uniform approach to the calculation of this ratio – and there cannot be due to national differences, among other things.

Especially in the retail business, the cost component is of major importance. Therefore, the intended refinements result in a multiplication of the work on site: obtaining documents, documentation, handover to the reporting systems, plausibility checking, clarification of delimitation issues etc. Therefore, we suggest allowing a continued application of the current simple approach. With a view to the further clustering of the exposure class, we object to a mandatory application of the granularity criterion (0.2% of the entire supervised retail portfolio). In particular for smaller banks with a small retail portfolio, the criterion would mean a very low maximal amount of credit, which would result in considerable impairment of competition. For example, in the case of a portfolio size of EUR 200 m, the maximal amount of credit would be EUR 400,000. Especially lending to SMEs would suffer under such a regulation. As a consequence, lending to SMEs would become substantially more expensive or be substantially reduced. Therefore, we suggest requiring proof of diversification of a retail portfolio not by means of a mandatory check of the granularity criterion, but to allow other methods as well. Moreover, as described in the Basel paper, there are cases that require national discretion as to the determination of the granularity criterion and the application of the retail business. This should continue to be the basis for handling, especially for the small banks.

Moreover, a “pollution quota” of 10% of corporates should be permitted in the retail segment if the corporates are decided on in the retail process. Due to the rather low volume of lending, balance sheets that would enable calculation of the required indicators are usually not available for these enterprises. The additional requesting and evaluating of the balance sheet entails disproportionate expenditure where the lending volume is low. A higher flat weight of 100% should apply to these loans.

<u>Claims secured by Real Estate</u>

Q10. Do respondents agree that LTV and/or DSC ratios (as defined in Annex 1 paragraphs 40 and 41) have sufficient predictive power of loan default and/or loss incurred for exposures secured on residential real estate?

Both ratios seem to have predictive power of loan default for exposures secured on residential real estate and are frequently used, although, some of our members are using other measures than the DSC when assessing whether a customer can afford to service a new loan. These other measures include, inter alia, standardised amortisations instead of the customer’s actual amortisation.

We would also like to emphasise that the risk weights on mortgages are far too high and should be thoroughly calibrated.

Q11. Do respondents have views about the measurement of the LTV and DSC ratios? (In particular, as regards keeping the value of the property constant as measured at origination in the calculation of the LTV ratio; and not updating the DSC ratio over time.)

We are of the opinion that it is not appropriate to globally harmonise a detailed system for risk weights for residential real estate. Different factors influence the risk incurred by residential lending, for example; the way the housing market operates, the systems of property valuation, registration, pledge of housing and design of legal and welfare systems. The risk with an exposure secured by real estate is not the same if the bankruptcy law allows people to walk away from debt compared to if there are no personal bankruptcy where debt is written off, meaning that the debt remains with a defaulting borrower until it is paid back. To the extent that risk weights are to be differentiated under the standardised approach the calibration should, therefore, be decided at national level. Additionally, there should be more granularity in the lowest LTV bands as this will increase risk sensitivity and enrich comparability across methods and banks. Furthermore, a greater difference between mortgage risk weights at low LTV bands and high LTV bands than proposed by BCBS could be studied. In any case, this should not entail an increase in risk weights for the higher risk classes which we do not deem necessary.

According to the proposal, the value of the property should be kept constant at the level assessed at loan origination when calculating LTV. We believe that this is an unreasonable approach, especially when the SA risk weights should serve as a reference point for disclosure and risk weight floors for IRB banks. An increased market value of the dwelling or an increased income of the borrower must be able to result in 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. Thus, LTV should change while the credit is redeeming. Our conclusion is that it should be possible to calculate the risk weight based on the current LTV.

The LTV ratio should be calculated using updated property valuations where such value updates are possible. A minimum frequency for the value update has to be established, but subject to national discretions since according to the jurisdiction the updates can vary from one to five years. The increased effort that will be needed for institutions to carry out these updates has to be taken into account. Furthermore, we would like to note that keeping the property value constant has several shortcomings:

- Firstly, the current LTV refers to the bank's risk if the customer defaults. Requirements for updated valuations will therefore give equal treatment between banks and engagements with equivalent risk. It is not sensible that the capital requirement for a given loan depends on the time of the granting of the loan.
- Secondly, a constant property value could weaken competition in the mortgage market. Falling house prices will cause a lock-in effect of borrowers since switching of banks result in a higher LTV, capital requirement and lending rate (ceteris paribus). In a market with rising house prices, the opposite effect will occur. If the customer switches bank, the capital requirement related to the mortgage will fall. The customer will thus have an incentive to refinance or switch bank.
- Thirdly, this type of regulation involves systemic costs. The bank's own risk is dependent on the value of collateral today - and the bank's own risk calculations should be based on updated property values.

Finally, on the LTV we will like to draw the Basel Committee’s attention to the fact that applying the risk weight to the whole exposure (i.e. without tranching the exposure across different LTV buckets) will pose some practical problems. Customers would then have the incentive to split the loans between banks (with first priority in Bank A and second priority in Bank B) as this would most likely give the customer better terms in total. Based on risk aspects it would therefore be justified to split the exposures secured by real estate into a secured share (e.g. LTV ratio of up to 60%) and an unsecured share, in contrast to the present proposal in the consultation paper, and hence admit a so-called real estate loan splitting.

With regards to the proposal on the DSC based on the borrower's net income we would like to note that the net income (i.e. income after taxes and social benefits) can be difficult to control for the lender. This is in particular the case for borrowers living in jurisdictions in which there is an established tradition of paying a part of the salary to a bank account and another part in cash. Net income is also not always comparable between countries as a result of, among other things, differences in health care and welfare systems designs (fiscal and privately funded systems). In some countries, a lot of costs for households might be paid over the tax bill (for instance health care, schools etc.) while for other countries the same costs are paid directly by the households. Differences in local VAT-rules will further complicate the picture. 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 might differ a lot between jurisdictions, at least between 10 and 50%, and it's obvious that DSC will not function as a risk driver in similar ways in different countries.

Furthermore, we consider that the DSC parameter should not stimulate increased repayment time and/or interest-only mortgages. The DSC includes amortisations and increases the more the customer amortises. It is, according to our mind, counterintuitive to assign higher risk weights the more the customer amortises. If the DSC should be a risk driver, amortisations should be excluded from the measure. Alternatively, the DSC calculations should be done on standardised parameters, such as a fixed repayment period.

Another major issue related to DSC is about the access to the current situation of the customer, that may dramatically change (not necessarily worsening) throughout the life of the credit, and some legal concerns appear about the collection of those data.

Q12. Do respondents have views on whether the use of a fixed threshold for the DSC ratio is an appropriate way for differentiating risks and ensuring comparability across jurisdictions? If not what reasonably simple alternatives or modifications would respondents propose while maintaining consistent outcomes?

DSC is a common indicator of the obligor's ability to pay used by several institutions in a loan's risk assessment in order to approve or deny a loan application. However, for the purpose of the Basel Committee proposal it needs to be frequently updated in order to reflect the current economic situation of the obligor. This will be burdensome for institutions and for the obligor, and it will imply the modification of contracts. Additionally, it has to be taken into account that its update depends on certain client information which can be difficult to obtain.

Should the DSC be withheld, the adequate threshold (35% on the proposal) should depend on the local income level, social security level, trade-off between VAT and income taxes, etc. as described in the answer to question 11 above. Some of our members consider it slightly demanding, as the markets where they operate may restrain the access to funding of retail clients. Due to this, it could be desirable to increase it to 40%.

Therefore, we consider that the DSC can work correctly in the first years of the credit but in the long term other risk drivers should be introduced.

Q14. Which of the two options above is viewed as the most suitable for determining the risk-weight treatment for exposures secured on commercial real estate?

Although both options suppose an increase of the current risk weights, we consider that option B could be more favourable to institutions since it takes into account the LTV, and this will be coherent with exposures secured on residential real estate. Pledged property should be considered as a significant risk reduction measure and this should be reflected in the risk measurement.

In our opinion national discretion for a preferential 50% risk weight should be maintained also for option B. Furthermore, the table should also be more granular, with lower risk weights for the lowest LTVs.

<u>Off-balance Sheet exposures</u>

Q18. Do respondents agree that instruments allocated .... and that the probabilities implied by the CCFs are accurate? Pease provide empirical support for your response.

We do not understand why, being designed to be aligned to Foundation IRB, the new SA shows (Table 1) an increase in the consumption of the commitments unconditionally cancellable, from 0% to 10%. Furthermore we are required to provide empirical support, when no empirical proof has been given for those "...consumer protection laws, risk management capabilities and reputational risk considerations..." mentioned in the consultative paper as the reasons for the change.

<u>Past-due Loans</u>

Q19. What are respondents' views on the alternative treatments currently envisaged for past-due loans?

It is preferable to adopt a treatment that allows a risk weight adjustment which may vary as a function of the amount of provisions. Provisions help institutions to diminish the risk of impairments and be prepared for a final default, so it will be appropriate to take them into account for the calculation of the risk weight for past-due loans.

<u>Exposures to Multilateral Development Banks</u>

Q20. Do respondents agree with the proposed treatment for MDBs?

In order to apply corporate exposures treatment to MDBs it is necessary to ensure that the risk indicators regarding exposures to corporates are available for multilateral development banks.

About WSBI (World Savings and Retail Banking Institute)

WSBI brings together savings and retail banks in all continents and represents the interest of circa 6,000 financial institutions with total assets of USD 14 trillion and serving some 1 billion customers in 80 countries worldwide (2013 figures). As a global institution, WSBI focuses on international regulatory issues that affect the savings and retail banking industry. It supports the aims of the G20 in achieving sustainable, inclusive and balanced growth and job creation around the world, whether in industrialised or less developed countries. WSBI favours an inclusive form of globalization that is just and fair, supporting international efforts to advance financial access and financial usage for everyone. It supports a diversified range of financial services that meet customers' transaction, savings and borrowing needs responsibly. To these ends, WBI recognizes that there are always lessons to be learned from savings and retail banks from different environments and economic circumstances. It therefore fosters the exchange of experience and best practices among its members and supports their advancement as sound, well-governed and inclusive financial institutions.

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About ESBG (European Savings and Retail Banking Group)

ESBG brings together savings and retail banks of the European Union and European Economic Area that believe in a common identity for European policies. ESBG members support the development of a single market for Europe that adheres to the principle of subsidiarity, whereby the European Union only acts when individual Member States cannot sufficiently do so. They believe that pluralism and diversity in the European banking sector safeguard the market against shocks that arise from time to time, whether caused by internal or external forces. Members seek to defend the European social and economic model that combines economic growth with high living standards and good working conditions. To these ends, ESBG members come together to agree on and promote common positions on relevant matters of a regulatory or supervisory nature.

ESBG members represent one of the largest European retail banking networks, comprising of approximately one-third of the retail banking market in Europe, with total assets of €6,749 billion, non-bank deposits of €3,415 billion and non-bank loans of €3,685 billion (31 December 2013).

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