

POSITION PAPER



WSBI-ESBG response to the BCBS consultation on revisions to the Standardised Approach for credit risk – second consultative document

WSBI (World Savings and Retail Banking Group)

ESBG (European Savings and Retail Banking Group)

Rue Marie-Thérèse, 11 - B-1000 Brussels

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WSBI



ESBG



Dear Sir/Madam,

Thank you for the opportunity to comment on the BCBS consultation on *revisions to the Standardised Approach for credit risk (second consultative document)*. In the first sections [a)-k)], WSBI-ESBG comments in general on the new consultative document. In the last section [l) Major drawbacks with using the SA as a reference point for floors and disclosure in IRB banks], we particularly focus on the aspects being relevant for a framework aiming to serve as a reference point for floors and disclosure in IRB banks.

a) General reflections

First of all, please allow us to state that we find it a bit difficult to comment on this proposal given the fact that this revision is an inseparable part of the larger Basel III reform package. This reform package will also, as notified by the Basel Committee on Banking Supervision (BCBS), probably remove internal model approaches for certain risks and introduce additional constraints on internal models. Moreover, a revised capital floor standard could be introduced for banks applying internal models, based on finalised standardised approaches. Hence, it is most demanding to comment on a set of proposals with comprehensive implications for other regulatory standards, in which only the former is made known to the general public. A full consideration would require the knowledge of each and all of the relevant revisions put forward by the BCBS. The WSBI-ESBG comments are thus contingent on the remaining Basel III amendments.

Furthermore, it would perhaps have been a good idea to adjust the timetable between the consultation period and the QIS exercise, which would have allowed stakeholders to make comments after the publication of the QIS results.

As indicated above, the BCBS is proposing an extended scope for the Standardised Approach for credit risk (SA). From now on, the SA will not only be the capital adequacy method for banks that use the standardised approach for calculating credit risk (SA banks) but also serve as a reference point for disclosure and for 'capital floors' (or more adequate, risk weight floors) in banks using internal models (IRB banks). This is very ambitious but could only work if there is an unambiguous relationship between the SA-risk weights and the actual risk of loss. WSBI-ESBG is however doubtful that the revised SA would be able to achieve this, and promote comparability by reducing unjustified variability in risk-weighted assets (RWAs) across banks and jurisdictions. We deem, inter alia, that the BCBS's focus on simplicity has resulted in a framework where risk weights are in many cases not able to reflect the underlying risk of losses in a consistent way. As a consequence, the capital floors for IRB banks could jeopardise banks' high risk sensitivity management developed thanks to IRB models in recent years and stemming from their generally high sensitivity to risk. We therefore propose that the BCBS abstains from using the revised SA as a reference point for floors and risk disclosure.

WSBI-ESBG is supportive of the idea of a strong alignment between exposures' inherent riskiness and the capital required for holding them. Such correspondence is a necessary prerequisite for the revised SA to provide the appropriate incentives and hence improve the financial stability outlook. This would warrant increased risk sensitivity beyond the committee's proposal.

Furthermore, in the context of level playing field discussions, one could consider re-modifying the leeway for national discretions. It is advantageous if the same basic methodologies were applied for the calculation of RWAs. If not, regulatory standards could generate excessive dispersion and impair cross-border comparability of capital adequacy. Consequently, the revised SA should be implemented in a more aligned manner across jurisdictions. Having said that, we would like to further underline that, on a more detailed level, if national laws have particular and justified rules on certain exposures (e.g. in the



real estate exposure class), which help to properly reflect the risk of the underlying exposure, they should not be abandoned.

What is more, in our opinion, overall capital requirements for SA banks must not increase at all, or at least not significantly following the implementation of a revised SA for credit risk. While it is true that the BCBS states an increase is not an objective of the revised framework, the risk weights in some assets seem to have a high impact on the capital requirements. In our opinion, the BCBS should bear in mind that there is a real risk of putting excessive pressure on overall capital requirements, at a time when the banking sector is already facing very demanding requirements as a consequence of the regulatory reforms undertaken in recent years. This is even more true considering that there are still numerous regulatory reforms of the financial sector pending. At the end of the day, the ability of banks to finance the real economy could be seriously challenged, in particular in the context of a still slow recovery of economic growth after the recent economic crisis.

Additionally, the consultative document does not say anything about a proposed date of implementation. Taking into account that the revised market risk framework should come into effect on 1 January 2019, is it possible that the BCBS has the same implementation deadline in mind for the revised credit risk framework? The adoption of many Basel III standards has included transitional arrangements by different jurisdictions.¹ They allow institutions to adapt gradually to the new framework, which we consider very important. It is necessary to allow enough time for institutions to finish the implementation to Basel III before asking them to comply with additional modifications, such as the ones followed by the revisions to the SA for credit risk.

b) External ratings and due diligence requirements

WSBI-ESBG very much appreciates the re-introduction of external ratings as a factor determining the risk weight of exposures. This is because external ratings aim at taking all relevant circumstances into account; both those related to the individual borrower, and to the business environment in which the borrower is operating. In several countries credit rating agencies (CRAs) have, as a consequence of the important role they played in the crisis, turned from unregulated and unsupervised entities to the opposite (i.e. ESMA is the European CRAs' supervisor), which makes the ratings they grant far more reliable.

According to the consultation paper, external ratings shall serve as a basis to calculate the credit risk of an exposure. Afterwards, banks need to carry out a due diligence process to make sure that the external rating appropriately and conservatively reflects the risk of the exposure. The BCBS points to the need of a due diligence process in order to reduce the mechanistic reliance on external ratings for the assessment of an asset's creditworthiness, following FSB principles. As a matter of fact, WSBI-ESBG would like to challenge this way of thinking. Banking institutions and many national/regional regulators have included for years in their practices the sound practices based on the Basel Principles for the Management of Credit Risk. Additionally, the creditworthiness of an asset is carefully assessed during the approval process. The exposures granted are also monitored over their whole life-cycle in order to immediately detect possible deteriorations in credit risk quality. All this is made irrespective of the approach used by a bank – be it the SA or IRB model – to calculate capital requirements due to the fact that this is an essential requirement in banking business in order to perform well. The calculation of regulatory capital requirements is and, in our opinion, should be, a mechanistic and automatic process that reflects, in part, the risk appetite of an entity and its risk management practices.

¹ For example, in the European Union, the Capital Requirements Regulation (CRR) entered into force on 1 January 2014, but foresees transitional periods up to 2019.



Furthermore, the BCBS recently issued its ‘Guidance on credit risk and expected credit losses’. We are of the opinion that regulators should try to have a more holistic approach with regard to different sets of regulatory proposals, taking advantage of synergies that avoid the duplication of efforts and the potential creation of inconsistencies between regulations. Although the aforementioned guidance is addressed to expected credit loss (ECL) for accounting, its implementation will imply the adoption of the credit risk management practices contained in it, if necessary improving the management practices that are already in place and avoiding the mechanistic reliance on external ratings for the assessment of asset creditworthiness.

One must take into account that many banks regularly apply standardised methods due to their difficulty in developing internal models. A too demanding due diligence requirement may, in the end, more or less force them to do so. WSBI-ESBG would furthermore like to point out the issue that banks are not specialised rating agencies. So it does not seem convincing to give them ‘the role of validators’ of specialised agencies’ ratings in the context of the due diligence process either. Banks should not be encouraged to call into question the work of rating agencies.

At any rate, according to our view, the due diligence requirement should be carefully analysed and managed because, depending on the way the requirement is materialised, it could have a very negative impact. Extraordinarily high due diligence requirements could be difficult to meet by smaller and less complex banks, putting into risk their business model. Additionally, for bigger and more complex banks, overly-demanding requirements would also result in very high costs and increased burden.

With regard to paragraph 15 (page 28) of the consultative document, which states that “banks should have in place effective internal policies, processes, systems and controls to ensure that the appropriate risk weights are assigned to counterparties”, WSBI-ESBG would like to ask for some clarifications. In our mind, it is certainly important that the aforementioned internal policies, processes, systems and controls are aligned with the current procedures of internal risk management (Pillar 2).

As a consequence of the above mentioned points, we are of the opinion that the possible adjustments of external ratings should not automatically imply the carrying out of due diligence procedures by banks. Furthermore, these adjustments could be limited to those cases where the abovementioned credit risk assessment of a client would suggest a more conservative rating than the external rating. This being said, WSBI-ESBG is – as outlined above – somewhat concerned by the introduction of a (so to speak) ‘simplified internal models approach’ into the SA. Hence, the BCBS could reconsider whether this approach actually fits into the spirit of the SA and its objective of promoting simplicity. In our opinion, the introduction of the due diligence leads to undue complexity in the SA framework and would open the door to introduce divergences in risk weights that are not linked to the underlying credit risk of exposures.

Apart from this, WSBI-ESBG is concerned about jurisdictional differences which could arise in relation to the implementation of the due diligence process, given the different requirements of regional regulators. From our point of view, risk weights should ideally be the same for a given level of underlying credit risk and potential regulatory/supervisory differences should not result in different risk weights.

The same is true with regard to the assessment of public support in ratings. In this regard, the BCBS suggests that banks assess aspects that have not been assessed before by rating experts. As stated above, banks are not experts in the assessment of ratings of corporations. In greater detail, the information the BCBS is asking for is often not provided to the market, which raises the question of how banks are supposed to carry out such ratings. Hence, the conclusions that we have drawn with regard to the due diligence above are also valid in relation to the assessment of public support.



c) **Bank exposures**

Although WSBI-ESBG believes the new BCBS approach is far more complete than the one proposed in the first consultation, we still have some concerns with regard to the treatment of bank exposures (in addition to the reflections presented above on the due diligence requirements).

In principle, the proposal to exclude public support from ratings is justified in order to break the link between banks and their sovereigns. In contrast to this objective, in the Standardised Credit Risk Assessment Approach (SCRA) used for unrated bank exposures, the BCBS proposes to introduce a risk weight floor aiming at capturing the macroeconomic environment and risks of the counterparty's country of primary operations, which is already included in rated banks. The BCBS asks respondents to share their opinion on both proposals (i.e. the exclusion of public support and the floor for unrated banks). While WSBI-ESBG understands the BCBS's intention and finds it logical and consistent on one side, we are afraid that the proposed solutions would add too much complexity compared to their scarce benefits on the other side.

In other words, we do not see the need of trying to split hairs in the SA for the sake of simplicity as far as there are simpler ways of capturing underlying risks to these exposures. In fact, we believe that, generally speaking, the SCRA should be simplified and more aligned with the External Credit Risk Assessment Approach (ECRA) in order to avoid unintended consequences in relation to its economic impact as well as its implications in the supposed reduction of unjustified variability in the assignment of regulatory capital requirements.

As a consequence, in particular following the lack of granularity proposed in the SCRA (just A to C grades starting at a risk weight of 50%), unrated bank exposures in countries with low sovereign risk would be unduly punished with a substantial increase in risk weights.

The banking sector in some countries is characterised by a few large commercial banks and several small, unrated savings banks. For the latter group of banks, which are primarily funded by deposits and which are in some countries indeed the ones with highest capital ratios, funding costs are expected to rise significantly due to the leap in risk weights. As a consequence, incentives to issue covered bonds will increase. Moreover, substantially higher funding costs for unrated, highly solid small banks are even able to threaten the existence of the respective savings bank model, which has been imperative for the supply of financial services throughout such countries.

As a potential alternative, one could consider re-introducing sovereign risks to serve as a floor for risk weights in the SCRA. Furthermore, one could also consider introducing more granularity in the SCRA for low risk exposures, e.g. introducing a new grade bucket ("A+") with a 20% risk weight for banks with a very strong capital and liquidity position, as well as additional adjustments to grades A, B, C and D.

In the absence of external ratings and potentially having sovereign risks as a basis, we believe that the use of capital and liquidity ratios could be a simpler and clearer way of assigning grades. Some of the triggers included in grade C could be used as long as they don't lead to the result that of different outcomes/risk weights for the same risks.

Regardless of the comparability between ECRA and SCRA, the elements for the determination of each grade should ideally be linked to the standards applied by rating agencies to rate banking exposures. At the same time, it is crucial that comparability and excessive complexity are well balanced. Considering



the elements mentioned in the paragraph above (e.g. capital and liquidity ratios) could acceptably achieve this objective.

Additionally, regarding the SCRA, WSBI-ESBG would like to share the following thoughts:

- According to paragraphs 20 to 22 (page 29) of the consultation paper, it seems that, in order to classify a bank exposure as grade A, such an exposure must comply with both of the following two requirements at the same time: (i) having adequate capacity to meet their financial commitments and (ii) exceeding the published minimum regulatory requirements and buffers established. Is this understanding correct?
- Paragraph 24 (page 29) of the consultation paper states that “a counterparty classified as grade B must meet the published minimum regulatory requirements established by its national supervisor as implemented in the jurisdiction where the borrowing bank is incorporated.” However, paragraph 24 does not say anything regarding the capital buffers, whereas they are mentioned on page 5 of the consultative document in order to be classified as grade B. WSBI-ESBG would like to ask for clarifications in this respect.
- The classification of a bank exposure as grade B or C depends on its repayment capacity. However paragraph 26 (page 29) of the consultation paper is somewhat ambiguous when it refers to “a material default risk and limited margins of safety.”
- The second bullet point of paragraph 27 (page 30) establishes the following trigger to classify an exposure as grade C: “Where audited financial statements are required, the external auditor has issued an adverse audit opinion or it has expressed substantial doubt about the counterparty bank’s ability to continue as a going concern in its financial statements or audited reports within the previous 12 months.” In our opinion, this trigger could be beneficial to banks based in jurisdictions where audited financial statements are not required, and detrimental for banks incorporated in jurisdictions where they are foreseen.

In relation to short-term interbank exposures WSBI-ESBG agrees with the proposal of maintaining preferential risk weights as this would accomplish the objective of improving market liquidity in inter-bank markets. However, one remaining concern is that the definition of short-term as 3 months is misaligned with some liquidity requirements, in particular the Net Stable Funding Ratio (NSFR). Indeed, we believe that it is crucial to align different regulatory requirements whenever possible. According to the NSFR, for some assets, the duration of firm funding must be at least 6 months to get partial credit and at least 1 year to get full credit. The problem arising from this misalignment is that banks could, so to speak, choose between being penalised regarding liquidity requirements or with respect to capital requirements.

Apart from this, the BCBS welcomes feedback on the appropriateness of implementing the FSB recommendation on banks public disclosure information about their credit assessment approach (pages 6 and 7 of the consultation paper). WSBI-ESBG believes that this has to be assessed very carefully, since one is here speaking about internal information that should not always be disclosed in greater detail in order to respect confidentiality (where necessary). Additionally, it should be taken into account that the banking sector is already subject to very high levels of information disclosure, compared to other sectors. It is therefore of great importance to analyse whether such delicate disclosures would still be in line with the goals intended by the decision-makers.

d) Corporate exposures

WSBI-ESBG strongly welcomes the recognition of external ratings for risk assessment purposes for corporate exposures. External ratings on corporate exposures are, however, limited and only cover a



few large corporates. The mid cap segment corporates without an external rating constitute a significant part of the total bank exposure to European companies. In the new proposal, exposures to the mid cap segment will obtain a flat risk weight of 100% in the ECRA. Against this background (banks' portfolios, the proposed risk weight, etc.) we need to draw the conclusion that the BCBS's proposal seems very punitive with regard to the segment of (very often) high-quality exposures to corporates. Additionally, this effect would be amplified by potential floors to IRB models. This could cause significant restrictions on loan provisions to this exposures segment, which would naturally be a very undesirable effect.

Moreover, the consultative document states that the BCBS considered applying a hierarchy of approaches (i.e. ECRA and SCRA) as the described for bank exposures, but it couldn't identify objective criteria to classify corporate counterparties into grades A, B or C under the SCRA. WSBI-ESBG disagrees with this statement. As the analyses carried out by some of our members show, banks have in recent years been putting into practice sound credit risk management practices, in particular to manage large exposures to corporate counterparties.

In the case of IRB banks, WSBI-ESBG believes that the BCBS could give more weight to banks' credit risk ratings² which are carefully supervised when approved and on their standards for credit risk management, particularly those related to the expected credit loss (ECL) for accounting purposes.

To achieve more granularity, it could also be considered adding one or more additional grade(s). This would be one of the easiest ways for ensuring a little more risk sensitiveness in the proposal without sacrificing simplicity.

Based on this, WSBI-ESBG would like to highlight that we believe that a more acceptable approach in order to reduce variability between jurisdictions without sacrificing simplicity or risk sensitiveness would consist in standardising inputs instead of outputs. To mention an example, in order to reduce variability in IRB models, the European Banking Authority (EBA) decided to standardise the definition of default, which is the main input in order to obtain IRB parameters for credit risk calculations. In the envisaged revisions of the IRB models, the EBA will probably propose the standardisation of some parameters that are inputs in calculations in order to obtain internal probabilities of default (PDs) and loss given defaults (LGDs). Following this example, the BCBS could also set more standard inputs in IRB models or its credit risk management standards. This would help be more confident in the use of their outputs afterwards, and would even allow for extending the scope of their use. In this way, the BCBS could set a similar scale for corporates to that of the SCRA for banks, without adding complex calculations or adding new rules to the remarkable amount of already existing ones.

In line with the use of the standards already set by the BCBS for credit risk management or for IRB models with regard to unrated corporates, we furthermore believe that in respect of rated exposures the due diligence requirement should be considered as fulfilled when sound credit risk management practices are in place in connection with the evaluation process for lending. This should be considered as fulfilled where IRB models for these exposures exist.

With regard to externally-rated corporates, we consider that proposed risk weights in jurisdictions that allow the use of external ratings are not granular enough in order to be considered as sufficiently risk-sensitive. In fact, to WSBI-ESBG, it seems difficult to justify the same risk weight (100%) for companies still rated as 'investment grade' (BBB) and for companies considered 'non-investment grade' (BB). There

² Internal credit risk ratings for large corporates have been based on models provided by external credit rating agencies such as Standard & Poor's or Moody's (due to the fact that these portfolios are usually low default portfolios). They are certainly very similar to those granted by the aforementioned companies to rate corporates.



is also a huge jump between best rated companies and the rest (from 50% to 100%). Moreover, when comparing the 75% flat risk weight for 'investment grade' in jurisdictions that don't allow the use of external ratings with the 100% risk weight for parts of the 'investment grade' companies in jurisdictions that allow the use of external ratings, there is, in our opinion no argument related to underlying risks that could explain this difference between both risk weights. In conclusion, we believe that the proposed 75% risk weight for 'investment grade' exposures in jurisdictions that don't allow the use of external ratings could be introduced to BBB-rated companies in jurisdictions that allow the use of internal ratings. This would introduce more risk sensitivity for unrated corporates under the ECRA and, at the same time, align the risk weight for these exposures with the SCRA.

The risk weights for corporates with an external rating BBB+ to BBB - below A - is too high compared to the inherent risk in these exposures. There are markets where history on default and loss given default for corporations with ratings from BBB+ to BBB- do not justify risk weights of 100%.

We very much welcome the lower risk weight for exposures to corporate SMEs, as these exposures have low correlation and often more physical collateral than larger corporates. As a matter of fact, we even consider that the risk weight (85%) for SMEs could be a little bit lower, in line with European legislation, namely 75%. Otherwise, the combined effect of higher RWAs and higher capital requirements could notably reduce the credit availability for SMEs. At any rate, there should be no national discretion to set the risk weight for SMEs higher than proposed by the BCBS in its consultative document.

Finally, we would like to ask the BCBS why the external rating of an entity within a corporate group cannot be used to help determine the risk weight of other entities of the same group (paragraph 100 in the consultative document), when it is obvious that there is a parent-subsidiary relationship. WSBI-ESBG believes that in cases of control of the subsidiary (51% of the ownership) the rating of the parent company should be used for the subsidiary, maybe notched. It is our opinion that this could be an area of greater analysis to be undertaken. In the end, this would facilitate the introduction of a more risk-sensitive framework for corporates, where large corporate groups exist.

e) Specialised lending exposures to corporates

WSBI-ESBG undoubtedly agrees with the need of giving a different treatment to specialised lending exposures and hence welcomes the BCBS's initiative of introducing a more risk-sensitive framework. Nevertheless, being dependent to a certain extent on the availability of external ratings (which are often rare regarding the specialised lending exposure class), we believe that there would be room for improvement to achieve the envisaged objectives. In fact, the proposed treatment is limited to three different, and relatively high risk weights (120, 100 and 150%), depending on exposures being either object and commodity finance or project finance in pre-operational phase or in operational phase. Although we perfectly understand that, for the sake of simplicity and standardisation, the SA cannot take into account the detailed information included in this kind of transaction, we have doubts whether the suggested risk weights aren't too high and the proposal too simplistic.

WSBI-ESBG believes that the BCBS's proposal does not appropriately reflect the underlying risks of the exposures. According to the consultative document, project finance would be treated as hard as defaulted exposures. In our view, this is unjustified because the particular structuring and collateral schemes of project finance exposures makes them, in practice, less risky than others. We also have the impression that the BCBS's proposal encompasses a high risk of penalising specialised lending expo-



asures in developing countries, where there is a high demand of assets and infrastructures that are typically structured as specialised lending. This could even have unintended consequences on global economic growth. There is furthermore the potential risk of biasing specialised lending towards most risky projects, because they are naturally more profitable, while the regulatory requirements stand the same as for less risky projects.

Unfortunately our assessments haven't shown any clear and concrete risk weights to suggest. At any rate, WSBI-ESBG would like to propose an approach that takes better into account the schemes and types of collateral. We believe that the slotting approach could serve as a useful basis for developing a more appropriate and risk-sensitive approach.

f) Subordinated debt, equity and other capital instruments

We welcome the adjustments made to the risk weights for equity exposures, compared to the first consultation paper. However, WSBI-ESBG believes that the proposed risk weights of 150% for subordinated debt and capital instruments other than equities and 250% for equity holdings are still too high and should therefore be re-considered.

g) Retail exposures

In the regulatory retail exposures category, it could be considered to change the granularity criterion, which states that, in principle, no aggregate exposure to any single counterparty should exceed 0.2% of the overall regulatory retail portfolio. This could again put smaller and less complex institutions in a difficult position. It is therefore crucial that banks are entitled to use other methods introduced by national supervisors to ensure a satisfactory diversification of the retail portfolio unless the 0.2% threshold of the BCBS proposal is lightened

Furthermore, it could be considered to apply more differentiation in the retail exposures category. For instance, exposures to SMEs could be allocated a lower risk weight than exposures to individual persons. In fact, we consider a risk weight of 60% to SMEs as appropriate (as this is a proxy to the SME supporting factor in the CRR and would keep the capital requirement on the level before Basel III), while exposures to individual persons could be risk-weighted at 75%. In this context, it is also important that the BCBS takes good note of the intra-EU discussions on the so-called SME supporting factor, which is an effective tool to help banks provide loans to the SME segment. It is fundamental that no measures are proposed in the revised SA framework that could have a negative impact on lending to SMEs. This is in our understanding also one of the big concerns of the EU regulators, given the importance of this segment to the EU economy as well as other economies around the world.

Once again, when thinking about using the SA later on for the determination of a capital floor for IRB banks, the issue of risk sensitivity comes up. We are confident that further risk sensitivity could be introduced into the framework without significantly reducing simplicity, for instance by taking into account maturity and credit risk mitigants for the determination of risk weights. We would appreciate if this idea would be followed-up by the BCBS.



h) Real estate exposure class

With regard to both residential and commercial real estate we have the impression that there are some cases where the proposed risk weights would conflict with paragraph 104 of the consultative document (when comparing identical transactions where credit risk mitigation (CRM) techniques have been applied or not). In the case of residential real estate this would occur when the property does not meet the operational requirements (paragraph 50), while in relation to commercial real estate this would occur when repayment is materially dependent on cash flows generated by the property.

With regard to the operational requirements, WSBI-ESBG is not fully convinced that all these requirements are really needed and would not unjustifiably exclude some property from preferential risk weights. Thus, we think that these operational requirements could be somewhat eased.

Generally speaking, we believe that CRM techniques which are allowed in the RWA calculation, shall also be allowed in the loan to value (LTV) calculation.

Residential real estate exposures

Taking into account that, firstly, the residential real estate market comprises a very important part of the banking business and, secondly, non-performing loan rates have remained low in many jurisdictions during the crisis, WSBI-ESBG believes the risk weight increase for this exposure category as not justified. Hence, the BCBS could re-consider the suggested risk weights and thereby keep in mind that significant increases in capital requirements should ideally be avoided.

We would like to propose applying one of the following two options: (i) a real recognition of less risky exposures for the lowest slot of the LTV ratios and to avoid cliff effects due to disproportionate risk weights increases for small LTV increases, maintaining the reference of 35% for 80% of LTV (as considered a reference value of a reasonable LTV for residential real estate)³ and (ii) the recuperation of loan splitting.

What is more, the introduction of a sufficiently long phase-in period in order to give banks the time needed to adapt to the new requirements needs to be considered, just as the application of the new requirements only to new residential real estate exposures. Long-term loans that have already been granted should not be made subject to a new regime in the middle of their life cycle.

On a side note, in WSBI-ESBG's view, more attention should be paid to limiting financing for land acquisition, where risks are usually much higher, instead of residential real estate exposures.

Moreover, WSBI-ESBG believes that the LTV ratio for residential real estate exposures should be calculated using updated property valuations in jurisdictions where such value updates are possible. Keeping the property value constant, as it is proposed in the BCBS's consultation paper, has several shortcomings:

- Firstly, a constant value will reduce risk sensitivity, in contradiction to the objective of the revisions. The LTV is a key risk variable, and an outdated LTV gives an incorrect measure of risk.
- Secondly, a constant property value could weaken competition in the mortgage market. Falling house prices would cause a lock-in effect of borrowers since switching of banks results in a

³ In our opinion, a whole exposure approach with risk weights ranging from 15 to 45% could avoid a general increase of capital requirements in these exposures, and at the same time incentivise the mortgages with lower LTVs.



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 operational costs. Risk depends on concurrent collateral values and risk calculations should thus be based on updated property values. Operating with two sets of property valuations, one updated for management purposes and one outdated for regulatory purposes, would be unnecessary and costly.

As stated before, WSBI-ESBG supports the option of loan splitting (versus “whole exposure”) in the allocation of exposure at default LTV buckets. There is an undesirable incentive to split the loan between different entities in case the loan-splitting option is not recognised. Furthermore, loan splitting avoids cliff effects as marginal increases in LTV would otherwise lead to disproportionate increases in risk weights. The loan splitting also better reflects the risk associated with junior liens as the risk weight of higher LTV bands increases accordingly.

Moreover, WSBI-ESBG does not appreciate the suggested calibration of risk weights for residential real estate when the repayment is materially dependent on cash flows generated by property. This seems counterintuitive in countries where lending represents an important part of the housing market. Hence, we believe that the BCBS could differentiate between different profiles of exposures where the repayment is materially dependent on cash flows generated by the property.⁴ This could be implemented by establishing some conditions that, if they are met, allow for the application of the same risk weights as it is used for residential real estate where repayment is not materially dependent on cash flows.

Apart from that, one should always bear the very different jurisdictional regimes in mind. The real estate sectors are highly influenced by national or regional legal considerations, which lead in the end to different underlying risks. In order to correctly account for these factors, the BCBS’s proposal on real estate could allow for some much-needed national discretions.

Commercial real estate exposures

WSBI-ESBG finds the suggested risk weights for commercial real estate unduly punitive. In particular, collateral seems poorly recognised, which would lead to excluding one of the collateralisation methods most used by SMEs. If capital requirements are too high in this exposure class, this could be potentially dangerous for the financing of SMEs.

Regarding commercial real estate we in fact believe that the BCBS’s approach could be aligned to the LTV of 60% in relation to the actual risk weights, as it is the case of 80% for residential property. Furthermore, the risk weights assignation should be more granular, avoiding a general increase in risk weights for these exposures, otherwise the collateralisation would lose its *raison d’être* and in many cases it could be preferred not to provide any collateral at all.

⁴ The objective of such differentiation would be to differentiate between specialised high quality agents in these markets from other cases where speculative agents could be really dependent of cash flows generated by the property.



i) Land acquisition, development and construction exposures (ADC)

WSBI-ESBG is a bit concerned about the proposed treatment for ADC exposures, which seem to have the same underlying risks than defaulted exposures, according to the BCBS (the only exposures that will for sure imply a loss to the bank). For both, a risk weight of 150% is suggested.

Regardless of the fact that the reason for this is stated in the document (uncertainty of the source or repayment at origination of the exposure), the proposed treatment does not recognise any tool that reduces such uncertainty, such as the sales that have taken place before the origination of the exposure or the issuances of some guarantees demanded in some jurisdictions.

From our point of view, the proposed risk weight jeopardises the ability of the industry sectors to access funding, which is a major issue for the industries that are a driver of growth, both in terms of employment and GDP. Although we fully agree that the BCBS should make provision for the incentives that lead to the last crisis, it should also avoid installing a treatment which can lead to unintended consequences for the real economy.

A way of introducing more risk sensitivity in the ADC exposures framework would be to use the LTV ratios with conservative haircuts capturing the construction process cycle, i.e. making a risk weight matrix reflecting the increased risk in early phases of the construction process and a more similar risk to residential or commercial real estate when the building is finalised (or almost finalised) and ready to be sold. In WSBI-ESBG's opinion, it does not seem justified to have such large leap in risk weights between property development and residential property at the time of the sale (e.g. 150% compared to 35% for a LTV ratio of 80%, according to BCBS's proposal). Hence, the property development should take into account the security value, with the tiering based on LTV ratios.

We also suggest exploring the expertise accumulated by countries where the real estate bubble led to important and painful lessons and, as a consequence, where industry practices have changed in order to incorporate a new risk management assessment using new risk drivers. National supervisors are in the best position to assess the new practices and determine some sort of exception in the general framework proposed. As an example, an important change carried out in the country of one WSBI-ESBG member has been the change of risk drivers from LTV ratios to loan to cost (LTC) ratios. This new approach is indeed more conservative from a risk assessment view because it avoids the incorporation of the expected increase in prices during the construction process. It also avoids the incorporation of inflated valuations in land acquisition. The cost during the construction phase incorporates the added value to land which is validated by specialised agents who control the budget execution.

In our view, the 150% risk weight proposed by the BCBS could be applied only to those exposures that are special purpose entities or special purpose vehicles (SPV), which have indeed a riskier profile.

Additionally we would like to ask for clarification whether the definition of ADC is meant to also capture social housing providers (supported in many cases by public entities).

j) Off balance sheet commitments

We are concerned that commitments to corporates are given the same risk weight regardless of the commitment being unconditionally cancellable (UCC) or cancellable with conditions, as this does not acknowledge the inherently different nature of these two types of commitments. This is because in the former case, the contracts are carefully studied by legal services in order to guarantee their enforceability.



In fact, in some of these contracts every disposable amount is previously approved, eliminating de facto the free availability of disposable amounts. We consider this should be recognised in the credit conversion factor (CCF) by giving it the value of 0%. WSBI-ESBG does not agree with the hypothesis that, in practice, these commitments are not UCC.

Apart from this, the consultative document imposes a 10% or 20% credit conversion factor (CCF) to be applied to retail commitments that are unconditionally cancellable at any time by the bank without prior notice. This charge would lead to an important increase compared with the current 0% CCF for these exposures. In our view, this is not justified with respect to certain credit cards.

In WSBI-ESBG's opinion, the BCBS could better take into account the operative differences across jurisdictions regarding the use of credit cards. For example, in some countries credit card debt balances are normally fully paid at the end of the month, while in other countries the use of revolving credit cards is much more extended, increasing the riskiness of the disposable credit balances. In our view, this is an important element that should be included in the new framework in order to not penalise banks incorporated in jurisdictions where the use of revolving credit cards is not widespread. We therefore propose to introduce a distinguishing factor based on the existence of an interest rate charge on the client account related to the credit card. If the credit card debt is fully paid at the end of the month, a 0% CCF could then be applied.

In respect of cash commitments, irrespective of whether they are UCC or not, WSBI-ESBG would like to add that the CCF is an estimate of the amount of the cash commitment that would be used in the event of a default. Normally, the use of the loan facilities is the highest immediately before a default, and we assume that this has been the BCBS's hypothesis. Nevertheless, we would like to highlight that this assumption could not be correct for certain types of commitments, particularly those related to large corporations. For these, the level of drawdown is especially influenced by business volumes that enable a company to obtain more funding for increased sales and trade volumes. In other words, drawdowns depend on the client's business cycle rather than on its proximity to default. A remarkable example in this connection can be found in cash pooling agreements with large corporates or insurance companies (high credit quality corporations) in order to have enough liquidity in peak months/days. Normally these agreements are structured with large disposable amounts or authorised overdraft facilities that have a very low frequency of use and, when used, are regularised overnight or in the next weekday. We believe these kinds of disposable amounts, whether UCC or not, have historically demonstrated their very low use, being only a facility to treasury management and should be assigned a CCF of 0% in order to not limit this liquidity management tool of larger corporations.

The proposal to assign a 100% risk weight to unsettled securities transactions might have a significant impact and should be further assessed as a part of the QIS.

k) Defaulted exposures

WSBI-ESBG agrees with the BCBS about the need of aligning the treatment of defaulted exposures under the SA and the IRB approach. We believe that the definition of default should be the same for both frameworks, as recently stated by the EBA in its consultation paper on the definition of default.

We also agree that, as far as capital requirements stand for unexpected losses, the risk weight to defaulted exposures should be applied only to the part of the exposure that is not already provisioned by being defaulted. Nevertheless we believe that it would be far too conservative, and too far from the IRB



approach, to apply a flat rate of 150% to all defaulted exposures. In our opinion, higher capital requirements over defaulted exposures are not the right means to cover shortfalls in provisions. Furthermore they would punish banks which use more conservative provisions, and in addition they could worsen the issue of pro-cyclicality.

With regard to defaulted exposures, variability in losses depends only on the LGD amount and this is recognised in the IRB approach with an elaborated framework that properly discounts and compensates losses. So no more than the potential volatility of LGD needs to be backed up by capital regarding defaulted exposures. In the proposed standardised approach, however, the capital charge for defaulted exposures applies to all exposures. This could result in significant differences in the actual scope of application of the charges and thus on the magnitude of the total capital requirements for defaulted exposures.

In our opinion, the risk weight applied to exposures in the SA should therefore be calibrated in a way that mirrors in an appropriate way the potential variability of losses, over and above the amounts already provisioned. Double counting needs to be avoided.

Based on the fact that losses occur only over defaulted exposures, capital adequacy considerations should focus on a bank's entire portfolio, (instead of only taking defaulted exposures into account in order to calibrate risk weights). WSBI-ESBG is confident that the final QIS data will show some more useful information in this respect.

For the time being, the BCBS could consider retaining a link to the level of provisions (i.e. lower risk weights for banks with high levels of provisions) until convergence to expected loss provisioning is further advanced.

1) Major drawbacks with using the SA as a reference point for floors and disclosure in IRB banks

The major drawback with using the SA as a reference point for risk weight floors and risk related disclosure is that the SA prescribes calculating risk weights in a very crude and standardised way for credit risk exposures grouped into a limited set of exposure categories. Building a relevant reference point, which should be applied worldwide and promote comparability, will only be possible if the chosen asset categories are homogenous worldwide from a risk perspective. According to our view, the asset categories chosen in the SA do not fulfil this requirement. The main reason for this is that there are essential differences between jurisdictions with respect to traditions, market setup, legislation and legal systems that have been neglected when defining the asset categories.

Moreover, the corporate sector, inter alia, is too diverse to allow for being aggregated into one corporate loan asset category which is homogenous from a risk perspective.

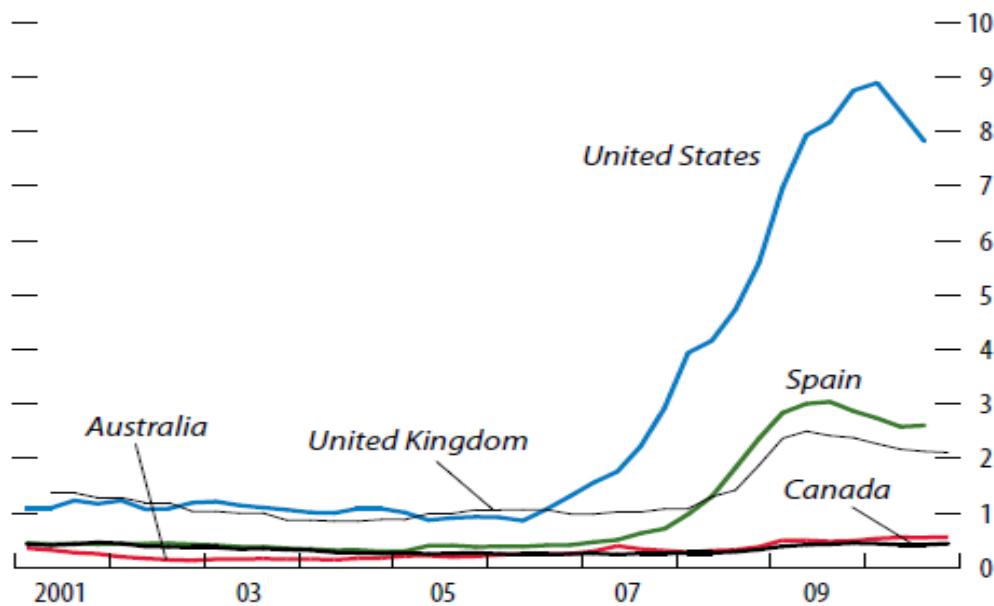
On top of this, variation in a bank's selection of individual exposures, which in part is affected by the capital adequacy rules, also makes it hard to define asset categories that are homogenous from a risk perspective through time and across banks. Individual banks may differ from each other in their preferences regarding which customers they would like to do business with, and their preferences may vary through time.



Residential real estate exposures

The risk weight for a mortgage (residential as well as commercial) is supposed to be determined by the LTV in the revised SA. The performance of residential mortgage loans vary significantly between different jurisdictions as illustrated in the graph below (Figure 3.8; copied from the IMF Global Financial Stability Report, April 2011).

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



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

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

The differences in performance between the jurisdictions displayed are striking, and it is hard to believe that they could be explained by systematic differences in the LTV between the countries. A part of the variation could probably be explained by differences in the development of the business cycle between the jurisdictions, but most likely other factors, such as local traditions and local legislation, are far more important.

Some central factors, which may have a huge impact on the risk of loss on a mortgage loan and which the BCBS has unfortunately not taken into account are, inter alia, to what extent the borrower is liable for the remaining debt if the collateral is sold at a price below the loan balance, or to what extent residential mortgages are combined with special guarantees or insurances, maybe with some kind of government backing, etc.



In one EU Member State, not recognising the mitigating impact of the National Mortgage Guarantee (NHG) on loan level recovery rates for residential real estate would lead to an unnecessary increase in required capital for the positions benefitting from this guarantee. Based on empirical evidence it can be shown that a NHG is an important risk mitigant that significantly reduces loss given default (LGD) levels. In order to calculate the appropriate RWAs and corresponding capital charges for this portfolio, the NHG covered loan parts should be risk weighted separately, taking into account an evidence-based recovery rate. Each bank which is active in the aforementioned Member State should have a very good view on the historical and actual recovery rates on this NHG. Therefore, we would like to propose that the BCBS reviews its position on sovereign guarantee schemes and, in collaboration with the respective National Competent Authorities, takes into account an evidence-based recovery rate to align required capital with the real risk associated to this portfolio.

Although the risk-weighted amount for a bank's residential mortgage portfolio, calculated in accordance with the revised SA, could have been able to say something about the LTV levels in that portfolio, it seems evident that it will not say very much about the risk level in the portfolio. To further complicate things, the risk weight of a mortgage, calculated according to the revised SA, will not be a reliable measure of the current LTV levels in the portfolio either, since the BCBS proposes that the LTV-levels, applied when determining the risk weight, should be calculated by dividing the current loan amount with the value of the property when the loan was granted, unless the supervisor concludes that there has been a general decline in residential market prices and therefore uses its discretion, provided for in the SA proposal, to require banks to revise the value downwards.

Since property values change through time, it will not be easy to translate information about LTVs, calculated on the basis of current loan balances and property values that can be either current or e.g. 10 years old, into a meaningful and comparable statement about the risk level in a mortgage portfolio.

Corporate exposures

Corporate exposures will, according to the revised SA, be split into exposures secured by real estate, specialised lending and other corporate exposures. The major part of the European savings and retail banking sector's corporate exposures are expected to fall into the real estate category and the other corporate exposure category.

The drawbacks with using LTVs, calculated according to the revised SA, will be similar for commercial real estate as for residential real estate. The risk mitigating effect of holding real estate collateral varies between jurisdictions, and property values change over time.

When it comes to other corporate exposures, the BCBS has chosen to use external ratings for rated enterprises when determining the risk weight. This seems to be an adequate approach when developing a reference point intended to be used globally, since external ratings take the particular circumstances of the rated firm and its jurisdiction into account in its rating process.

However, for corporates lacking an external rating, the risk weight will be 100% unless the annual turnover of the firm is lower than EUR 50 million. Then the risk weight will be 85%. These risk weights will apply to performing loans regardless of the firm's domicile or in what industry it is operating in. Within most countries there seems to be a systematic variation in loan losses on corporate loans depending on the kind of business the enterprise is active in. In addition, there could be huge variations in the credit quality between individual firms, and furthermore, there seems to be significant systematic variations between the credit quality of corporates from different jurisdictions depending on local traditions, legislation and to what extent the rule of law applies. Hence, it is, in WSBI-ESBG's view, not



very likely that the SA risk weights would provide any relevant information about the credit quality of a particular bank's corporate loan book.

Retail exposures

Retail exposures will, according to the revised SA, be split into ordinary retail and other retail exposures. The dominating part of the retail exposures will in most jurisdictions be classified as ordinary and receive a 75% risk weight. Other retail exposures will receive a 100% risk weight. Retail credit risks are likely to vary significantly between jurisdictions depending on local legislation and traditions. Applying one and the same set of risk weights on retail exposures regardless of how local household safety nets are set up and performing will hence not promote transparency about banks' exposure to retail credit risk.

To conclude

Neither risk weights for mortgages nor for corporate or for retail exposures, calculated in accordance with the revised SA, would be suitable for serving as a reference point for risk-related disclosures or floors, and if used as such a reference point they will, according to our opinion, not promote comparability by reducing unjustified variability in risk-weighted assets across banks and jurisdictions. WSBI-ESBG therefore proposes that the BCBS abstains from using the revised SA as a reference point for floors and risk disclosure.



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 16.7 trillion and serving some 1.3 billion customers in 80 countries worldwide (2014 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, WSBI recognises 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.



World Savings and Retail Banking Institute - aisbl
Rue Marie-Thérèse, 11 ■ B-1000 Brussels ■ Tel: +32 2 211 11 11 ■ Fax : +32 2 211 11 99
Info@wsbi-esbg.org ■ www.wsbi.org

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 €6,702 billion, non-bank deposits of €3,485 billion and non-bank loans of €3,719 billion (31 December 2014).



European Savings and Retail Banking Group – aisbl
Rue Marie-Thérèse, 11 ■ B-1000 Brussels ■ Tel: +32 2 211 11 11 ■ Fax : +32 2 211 11 99
Info@wsbi-esbg.org ■ www.esbg.eu