



March 27, 2015

Mr. Frank Pierschel and Mr. Caio Fonseca
Co-Chairs, Task Force on Standardized Approaches
Basel Committee on Banking Supervision
Centralbahnplatz 2, Basel
Switzerland

Re: Comments on the proposed revisions to the credit risk standardized approach

Dear Messrs Pierschel and Fonseca:

The Institute of International Finance (IIF), the Global Financial Markets Association (GFMA), and the International Association of Credit Portfolio Managers (IACPM; and together, the Associations) appreciate the opportunity to comment on the Basel Committee on Banking Supervision's (BCBS) proposed revisions to the credit risk standardized approach (SA). The Associations would also like to thank the BCBS Task Force on Standardized Approaches (TFSA) for the opportunity to raise with them in person some of the industry's comments on the proposals at the meeting in Frankfurt on February 24.

At the meeting with the TFSA, we believe everyone acknowledged how challenging the work of revising the credit risk SA is, especially since the new SA framework is intended to be applicable across all types of banks and to be used as a basis for the proposed capital floors. Hence, we are of the view that it is simply not realistic to aim for an end-2015 deadline to finalize the proposed revisions. Not only will it be challenging to develop the conceptual framework within this time period, but sufficient time is also needed to conduct a careful impact analysis to ensure appropriate calibration and impact assessment. Moreover, credit risk is the cornerstone of the BCBS capital framework and is the most important risk category for most banks, so we believe it deserves a more thorough review. We reiterate therefore our request to extend the timeline for this review beyond the planned end-2015 deadline. This extension should be able to accommodate an iterative quantitative impact study (QIS) process that allows institutions to provide good quality data necessary for supporting an appropriate calibration and impact assessment of the revised credit risk SA.

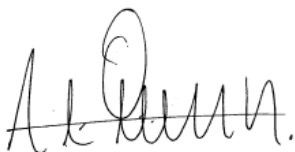
The timing issue aside, we would like to stress that the Associations and our members are ready and committed to assisting the TFSA in completing its work. In this regard, we offer in the attached document some general remarks as well as detailed comments and alternatives on specific elements of the proposals. The extensive nature of the issues that remain to be resolved as well as the need to

measure and test quantitatively many different alternatives reinforce the importance of continuing an active dialogue with the industry as the proposals are further developed. As always, we welcome continuing our interaction with the TFSA and discussing and exploring further the points in this letter.

Finally, we would like to note that we are planning to conduct an analysis on loss experiences on a few exposure categories, and are planning to submit to and welcome a discussion of the results of such analysis with the TFSA.

Should you have questions on our comments, please feel free to contact the undersigned or Jermy Prenio at the IIF (jprenio@iif.com).

Very truly yours,



Andrés Portilla
Managing Director
IIF



David Strongin
Executive Director
GFMA



Som-lok Leung
Executive Director
IACPM

COMMENTS ON THE PROPOSED REVISIONS TO THE BCBS CREDIT RISK STANDARDIZED APPROACH

1. General comments

Suggested approach in undertaking the review

Currently, there are several in-process regulatory changes not just coming out of the Basel Committee, but also from regional and national regulators. We believe these changes need to be implemented consistently and given an opportunity for the market to learn to use them before introducing more complexity or further changes (which may obscure rather than help stakeholders) – e.g. Basel III changes and increased disclosure are still in progress. Further, the leverage ratio is already a risk-insensitive standardized approach that provides a way to compare banks with different risk-based ratios and will be disclosed and become a tool for the markets. The BCBS should give the market a chance to use the leverage ratio and other disclosure reforms before determining that comparability of ratios is inadequate or that the credit risk standardized approach needs to be revised. If it is determined that there is not enough comparability, the BCBS should first require increased disclosure by advanced approach firms against the current SA and let the market try to use that information before making wholesale changes to the SA or using the SA to introduce new floors. This respects the important principle of minimizing unnecessary change and avoiding change that will have unintended consequences.

Given the increased use of SA (e.g. in the US) and the proposal to use it as a basis for an advanced approach floor, the new SA has the potential for very significant consequences including causing banks to take increased risks, to reduce risk management and to withdraw and extend credit to different borrowers due to the SA capital requirements. This would be a major disincentive for internal-ratings based (IRB) banks to continue to invest in data infrastructure for model development. Years of study in all jurisdictions affected by these changes should take place before implementation.

If there are going to be revisions to the existing credit risk SA, we strongly recommend that the BCBS focuses on making targeted improvements, leaving areas where the framework currently works sufficiently well unchanged. In this case, we would recommend that only the treatment of unrated corporate exposures, exposures secured by residential real estate (RRE), and the use of national discretions under SA be revisited at this stage, along with a reduction in other retail exposure risk weights to take into account non-financial collateral.

How portfolio risk is taken into account

The consultation document states that the revised credit risk SA should be suitable for a wide range of jurisdictions and banks. For the sake of clarity and also to assist in achieving sensible outcomes when the SA is used to constrain the acceptable range of outcomes that internal model based capital measures can set, the Basel Committee needs to explicitly state what kind of bank the SA capital requirements are calibrated to. The reality is that exposures that appear at face value to be similar, if not identical, present very different risks depending on the nature of the overall portfolio the exposure is a part of. The risk of a residential mortgage will differ across different jurisdictions for a variety of reasons. However, even within a jurisdiction, the risk of a residential mortgage portfolio originated by a small

bank with high concentration risk will be fundamentally different from that originated by a large bank with a portfolio spread across the whole country. The same principles underpin every risk class and range of risk weights the SA covers. Without some clear statement of how this question of portfolio risk is addressed, it is difficult to see how the question of floors tied to the standardized approach can be addressed in a coherent, comparable and consistent manner.

Reliance on external ratings

One of the high-level principles that guided the Basel Committee's development and evaluation of the policy proposals (Principle 5 in Section 1.3 of the consultation document) is to reduce or remove, where possible, reliance on external ratings in the credit risk SA. The Basel Committee, however, appears to recognize that it may not be feasible to entirely remove external ratings from the framework¹ and its primary concern is to ensure that ratings do not become "...a substitute for credit analysis". We would also like to add that the G-20 mandate is to *reduce* reliance on external ratings.² Thus, Principle 5 appears to already go beyond this mandate.

In the spirit of engaging constructively with the Basel Committee's stated objective, we offer suggestions on how the proposals might be refined to better achieve the objectives of simplicity and risk sensitivity. However, we are forced to conclude that the "simple financial ratios" approach, more often than not, fails to meet one or both of the desired simplicity and risk sensitivity criteria.

In considering the need to remove references to external ratings, it should be noted that criticisms on the performance of and overreliance on external ratings during the crisis focused more on certain asset classes, notably on securitization and sovereigns, and not really on ratings for corporates and financial institutions.³ Also, pre-crisis overreliance on external ratings was mostly observed on the buy/investment side. The fact that the new Basel securitization framework still uses external ratings, as does the new market risk framework (particularly for the default risk component) being proposed under the FRTB, offers further evidence that complete removal is both unnecessary and undesirable.

After the crisis, there have been a slew of regulatory developments aimed at the use of credit ratings or at credit rating agencies (CRA) themselves that should help mitigate regulatory concerns. For example, Basel III already introduced a number of measures that aim to address reliance on external credit ratings. In addition, credit rating agencies in the EU are now under the supervision of the European Securities and Markets Authority (ESMA). In the US the Securities and Exchange Commission's (SEC) has enhanced regulatory power over credit rating agencies. The Financial Stability Board (FSB) issued the ***Principles for Reducing Reliance on CRA Ratings*** (October 2010), which notes in Principle III.2 (Prudential supervision of banks) that "supervisory processes should be put in place to check the understanding of the appropriate uses and limitations of CRA ratings..." where external credit ratings are used for capital requirement purposes.

¹ "For the moment, the Committee has chosen not to rely on ratings as a risk driver..." Page 5 of the Consultation Paper (emphasis added)

² See the official declarations from the Seoul and Cannes G-20 Summit (https://g20.org/wp-content/uploads/2014/12/Seoul_Summit_Document.pdf, https://g20.org/wp-content/uploads/2014/12/Declaration_eng_Cannes.pdf)

³ For example, the Basel consultation on Strengthening the resilience of the banking sector (December 2009) noted that there was "excessive reliance by many market participants, including banks, on external ratings, **particularly for securitization products**..."

We agree that due diligence by banks in their lending and investment practices should never be limited to external ratings. However, the concern about overreliance on external ratings seems less applicable to the credit risk SA. Unlike banks operating under IRB that are expected to use their internal ratings for both risk management and regulatory capital purposes (the “use test”), banks under the credit risk SA are not supposed to nor encouraged to align their internal risk management with their Pillar 1 capital measure. Likewise, regulators would presumably not want SA banks to over-rely and limit their due diligence to the proposed two risk drivers identified for regulatory capital. This would contradict Recommendation 3 of the FSB’s *Thematic Peer Review on Reducing Reliance on CRA Ratings* (Thematic Review, May 2014), which states that “national authorities should guard against the temptation to adopt a small number of alternative measures...of assessing creditworthiness in place of CRA ratings.” The move away from external credit ratings in favor of simple risk factors (e.g. leverage and revenues as is being proposed for corporate exposures under the SA Credit Risk) is actually an imposition of a highly rudimentary two-factor model which no IRB bank would use, and no regulator would authorize, as an appropriate representation of risks and would even be an unreliable relative ranking of risks.

Large internationally-active banks are generally using IRB approaches using internal risk measurement tools and models complemented by thorough credit risk approval processes involving credit risk committees, and are further subjected to the use test requirements. So even if these banks are required to calculate SA capital for capital floor purposes, having reference to external ratings in SA would not lead to reliance by these banks on such ratings.

Because of all the points we raised above, we believe the continued use of external ratings supports the BCBS’s simplicity and comparability objective and avoids the unintended consequences of a “one-size-fits-all” approach. However, we are also aware of the constraint that the US in particular has imposed on the use of external ratings. Thus, in the spirit of contributing to a compromise solution, we offer below some recommendations. We nevertheless would like to reiterate the point mentioned above that the G-20 mandate is to *reduce* reliance and not to *remove* the use of external ratings. *Reducing* reliance on external ratings should therefore be the minimum yardstick against which all jurisdictions should be measured. If a jurisdiction chooses to go beyond that minimum requirement of reduced reliance on external ratings and impose something more stringent on its banks, it should be free to do so but other jurisdictions should not be expected to follow. This is consistent with the long-standing stance of the BCBS that it sets only minimum standards but member jurisdictions are free to go above and beyond those minimum standards.

Our recommendation therefore is for external ratings, where available, to be used as a starting point in determining the risk weights for corporate exposures but complemented by other risk drivers (for bank exposures, please see our recommendations below). If the other risk drivers clearly show evidence that the risk weights corresponding to the external ratings are not justified, then adjustments should be made. Where external ratings are not available (e.g. small- and medium-sized entities (SMEs)) or allowed, a fallback approach should be used. This fallback approach, for example, may allow the use of banks’ assessments of whether or not a counterparty is investment grade and assign risk weights accordingly. Such assessments should use clear and transparent criteria for rating exposures as investment grade or non-investment grade. The criteria could include appropriate risk drivers and should be made pursuant to a bank’s transparent and supervised master rating scale (i.e., used consistently for all of its borrowers and mapping to external ratings). The assessment criteria should provide evidence

that the counterparty (or protection provider) has an adequate capacity to meet its financial obligations for it to be considered as investment grade. This means that the risk of counterparty default is low and the full and timely repayment of principal and interest is expected.

Risk sensitivity and potential pro-cyclicality of the risk drivers

It is unlikely that the use of the proposed risk drivers can lead to more risk sensitivity. This is especially the case for bank and corporate exposures where external ratings (which factor in a lot of information) are replaced by an approach that only looks at two risk drivers. As to the other exposure types, granularity seems to be equated with risk sensitivity. Granularity may add to risk sensitivity only if the risk drivers used actually capture risk; otherwise, it does not improve risk sensitivity at all. Moreover, as alluded to in the consultation document, there is also concern that the use of uniform risk drivers, which may not necessarily be relevant or would have to be calibrated differently by jurisdiction or by industry, may only result in a false sense of comparability while leading to unintended consequences (e.g. inadvertently putting at a disadvantage firms in certain jurisdictions or industries).

The use of the proposed risk drivers (e.g. Common Equity Tier 1 (CET1), net Non-Performing Assets (NPA), leverage, revenue) also raises concern that it would make the regulatory capital framework more procyclical. Under ***Basel III: A global regulatory framework for more resilient banks and banking systems***, the BCBS outlined a number of measures to make banks more resilient to such procyclical dynamics (paragraphs 18-31). The introduction of the proposed risk drivers could negate the gains achieved by these measures.

Risk sensitivity and complexity

The proposed changes would likely result in more complexity in implementation, and the challenges would be especially acute for smaller banks. First of all, the proposed risk drivers do not have harmonized definitions across jurisdictions, so implementing them in a comparable way would be challenging. Further, the required information may not be readily available (or at least not in the same definition as envisaged by the proposals) to bank processes involved in regulatory capital calculation. The proposals would therefore likely lead to considerable IT investments. Limited information will also lead to higher capital charges that could worsen the impact of the proposed revisions.

Principles 2 and 3, Section 1.3 of the consultation document clearly shows the competing objectives that the BCBS tries to reconcile in the proposed credit risk SA. On the one hand, it wants more risk sensitivity to accommodate overall policy objectives. On the other hand, it wants a simple framework that is suitable for a wider range of jurisdictions and banks. The BCBS has always maintained that the Basel regulatory capital framework is intended for internationally active banks to address level-playing field issues. These banks should be the focus of the work on the new credit risk SA where the proposed revisions cannot satisfy both internationally active and local banks.

Likely impact of the proposed revisions

The executive summary of the consultation document states that “increasing overall capital requirements under the standardized approach for credit risk is not an objective of the Committee; rather, capital requirements should be commensurate with underlying risk.” The proposed changes,

however, indicate that capital requirements would increase particularly for high-quality portfolios. For example, the lowest risk weight for bank exposures would increase from 20% to 30%, while that for corporate exposures would increase from 20% to 60%. In addition, the credit conversion factor (CCF) for unconditionally cancellable commitments would increase from 0% to 10%, and the CCF for other commitments, regardless of maturity would increase from 20% or 50% (depending on the maturity) to a uniform 75%. On the other hand, the highest possible risk weights would be generally the same (except for extreme cases such as banks with CET 1 ratio less than 4.5% and corporates with negative equity, which would receive a 300% risk weight). Hence, it appears that the proposed revisions would only penalize banks with high quality portfolios, while somehow maintaining the capital requirement for banks on the other end of the spectrum. This could potentially result in wrong incentives for banks using credit risk SA and is not conducive to creating an approach that is more appropriate for the purposes of determining a possible capital floor.

Interaction with other BCBS standards

The consultation document explicitly excludes credit risk exposures that are subject to distinct capital requirement frameworks. In particular, over-the-counter (OTC) derivatives are excluded as they are subject to the standardized approach for counterparty credit risk (SA-CCR). At the same time, Principle 4, Section 1.3 of the consultation document states that the standardized approach should not rely on internally modelled approaches. This is the rationale given as to why internal measures of exposures for traded products (value at risk (VaR) and internal model method (IMM)) are no longer allowed under the proposed credit risk SA. This raises questions as to whether and how the treatment of OTC derivatives depends on the treatment chosen under the general credit risk framework (e.g. if a bank is under the general credit risk SA, could it use IMM for OTC derivatives?). We would like to confirm that a bank's choice of approach for OTC derivatives is independent of its choice of a general credit risk approach (i.e. SA or IRB).

Another inherent difficulty of developing a new credit risk SA is that there are so many moving parts to its calibration. For example, changes to CCF influence the leverage ratio (the calibration of which still needs to be revisited), the large exposure framework, and the scoring for global systemically important banks. The reference to CET1 ratios for bank exposures means that the calibration question is circular (i.e. calibration of bank risk weights will be based on current CET1 ratios, but the introduction of SA floors leads to lower CET1 ratios for banks in the future, which in turn lead to higher risk weights). The new credit risk SA will also impact the securitization standardized approach where underlying risk weights based on credit risk SA are used. This in turn will change the alignment between the different securitization capital approaches. Moreover, this will impact the floor calculation, which also includes securitization exposures. Finally, the new credit risk SA impact on risk weighted assets (RWAs) will also have implications on the TLAC calculation. All these factors need to be considered and a holistic assessment of these interactions needs to be undertaken.

Need for in-depth analysis

We therefore believe that an in-depth analysis should be undertaken to gauge the impact of the proposed revisions to the credit risk SA, and the cross-impacts on the different BCBS standards. In this regard, the industry supports the QIS on credit risk SA, subject to our recommendations expressed in our letter dated February 20, 2015.

We believe, for example, that the proposed changes are likely to impose incremental market entry barriers for entrant banks and, as such, will reduce competition as they will create additional complexity and data requirements in the calculation of credit risk SA.

Currently, smaller or regionally-oriented banks with relatively simple business models have a choice of using external ratings under the credit risk SA. If they do, under the Basel II framework for sovereign, bank and corporate exposures, risk-weights of 20% or 50% are available for investment grade exposures (up to 100% for corporates), 100% for non-rated exposures (as low as 50% under Option 2 for banks) and 150% for sub-investment grade exposures.

To now require a risk-weighting of 300% for exposures for which certain risk drivers are not available is a significant change in the fundamental approach of applying risk-weights and should only be implemented once the results of a QIS are available and an impact assessment has been completed. The current challenge is that within the timeframe available for the current QIS, banks will unlikely be able to source all the necessary data to reliably estimate the final impact of the penalty 300% risk-weighting.

For entrant banks, this change in the paradigm will require significant investment in regulatory capital reporting processes so that an unsustainable penalty risk-weighting of 300% can be avoided. We are concerned that the additional complexity of the credit risk SA will therefore introduce barriers to entry for new banks and complexity to small funders who may not have the capacity to absorb the additional reporting requirements.

We also believe there is a need to have a careful assessment of the appropriateness of the proposed risk drivers (as well as examine other risk drivers). We would support any effort by the Basel Committee to conduct a more extensive risk driver analysis. We would also like to request that the Basel Committee make available the analyses that have already been performed, which served as the basis for the proposals. Indeed, some parts of the consultation document refer to analyses performed that support the appropriateness of the proposed risk drivers. Our concern is that these analyses may be based on past data that may no longer be meaningful in anticipating future performance due to the many structural changes introduced after the crisis. In addition, the results of the analyses may be true for "average" banks (if such a bank exists) but not for most other banks that will fall either above or below this average. Hence, while the capital requirement may be appropriate on average across the industry, it is likely to be overestimated or underestimated at the individual bank level where it truly matters.

We are planning to conduct an analysis on loss experiences on a few exposure categories, and are planning to submit to and welcome a discussion of the results of such analysis with the TFSA.

2. Bank exposures

For the definition of bank exposures in the consultation document, it should be enough to say that a bank refers to any financial institution that "is subject to the prudential standards and level of supervision in accordance with the international practices relevant for such an institution" (paragraph 12 of Annex 1). The phrase "licensed to take deposits from the public" is not necessary and would actually

not work in some jurisdictions where the regulatory framework is also applied to non-deposit taking institutions which have a banking license, so we suggest for it to be deleted.

Concerns about the proposed risk drivers

The consultation document states that the two proposed risk drivers outperform the external ratings-based approach in predicting bank failure. We are keen to get a better understanding of this analysis and the data sample used. We note, however, that given the substantial enhancements made to rating methodology by both major rating agencies, it is difficult to see how the analysis would offer any insight into the performance of the current methodology relative to the proposed risk drivers.

As already mentioned above, we believe the use of CET1 and net NPA ratios would make the standardized capital requirements for banks more procyclical. This would lead to higher capital requirements for banks in a downturn environment, thus compounding the risks that banks would be facing in such an environment. This is especially true as banks will likely face declining CET ratios in a downturn, which in turn leads to higher risk weights that could further impact cost of funding when they most need it.

On the use of the CET1 ratio or any other capital ratio, the calculation of these ratios continues to evolve as the BCBS continues to make revisions to the Basel capital framework. For example, as mentioned in the general comments, the use of a SA floor will increase RWA across many banks without actually changing the creditworthiness of these banks. To maintain a consistent calibration based on the actual creditworthiness of counterparties, the credit risk SA will need to be adjusted every time the calculation of RWA is changed.

On the question of whether the CET1 ratio is the appropriate capital adequacy ratio to use, we note that CET1 is a measure of going concern viability and confidence while total capital is a measure of a counterparty bank's exposure to loss. As the credit risk SA should be trying to provide capital for unexpected loss, the total capital ratio rather than the CET1 ratio is the more relevant metric (although still not as good as credit ratings) – e.g. if a bank fails due to low CET1 but has sufficient non-common capital, its senior creditors may experience no loss. This is particularly important given contingent capital, non-viability capital and bail-in regimes. However, as recognized in the consultation document, the use of capital ratios can be distorted by national discretions, national buffers and Pillar 2 requirements, which make the ratio not comparable across jurisdictions.

The consultation document also mentioned the issue that would arise from using a risk driver that is predicated on a risk-based measure, such as the CET1 ratio. More questions arise if such CET1 ratio is based on advanced approaches under the Basel framework since Principle 4 of the consultation document explicitly states that “the standardized approach should not rely on internal modelled approaches to set capital charges”. Thus, the Basel Committee should clarify the basis for the CET1 ratio that would be used as a risk driver (i.e. is it the CET1 ratio under the standardized approaches, under the advanced approaches, or under the floor-adjusted advanced approaches?).

The consultation document already recognized the concerns about applying the proposed risk drivers on banks that are not subject to the Basel regulatory capital framework. Application of a 300% risk weight to banks that are not under Basel III seems punitive. It could lead to an uneven playing field

and unwillingness to lend to banks under different regulatory capital regimes. The proposal needs to be rethought for locations such as the US where only large banks apply Basel III, as well as to Emerging/Frontier Markets where funding at a pricing commensurate with risk is key for markets to have affordable funding sources.

A related issue is the proposal to include CET1 and net NPA ratios in Pillar 3 disclosures, which would have implications on banks that are not subject to Pillar 3. The Basel Committee explicitly states that the Pillar 3 framework is applicable to all internationally active banks.⁴ The proposal, however, would force even savings and cooperative banks to comply with Pillar 3 requirements in order to avoid the punitive 300% risk weight.

Even if Basel III has been implemented, local implementation usually includes deviations from international standards (in some cases, some jurisdictions apply only parts of the Basel standards). It is not clear how application of Basel III will be measured. For example, would this just be based on official policy statements of the respective jurisdiction or would the Basel Committee refer to its own Regulatory Consistency Assessment Program (RCAP) assessments to determine whether banks calculate their capital ratios in accordance with Basel III? From an EU implementation perspective, for example, would the consequence of the proposal be that only jurisdictions deemed to have equivalent supervision would be deemed in accordance with Basel III? For banks in jurisdictions that do not meet the “Basel III-stamp of approval” (in whatever way this is measured), should they separately calculate and disclose CET1 ratio based purely on Basel III definitions so as not to receive the 300% risk weight? Ideally, there should be a harmonized metric to achieve the comparability objective. However, the issues outlined above highlight the implementation challenges that supervisors and banks will be facing in trying to replace the external ratings-based approach.

There is also concern that the quality of disclosures is not the same across jurisdictions, with some better than others. Thus, relying on disclosures as source of information on the same risk drivers does not guarantee comparability.

We are also uncertain how the BCBS envisages applying in practice paragraph 17 of Annex 1 of the consultation document, which states that a 300% risk weight applies where a bank is aware that its obligor bank has breached “**any binding minimum prudential standard** to which they are subject by their national supervisor”. There are many prudential standards applied at the national level (in addition to those agreed at the Basel-level) so this requirement seems all encompassing and open-ended. We would therefore like to seek clarification as to what these prudential standards are, and confirmation that “awareness” of such breach should only come from banks’ publicly disclosed information.

NPL definition

We suggest that the definition of non-performing loans be aligned with the definition of default under the internal ratings-based (IRB) approach of Basel II.⁵ This would be consistent with objective (iii) of the proposed revisions, which is to “increase comparability of capital requirements under the standardized approach and the internal ratings-based (IRB) approach by aligning definitions and

⁴ Paragraph 19 of the BCBS consultative document on the *Review of the Pillar 3 disclosure requirements*, June 2014

⁵ Paragraphs 452-457 of the BCBS document on *International Convergence of Capital Measurement and Capital Standards*, June 2006

taxonomy, where possible". However, greater clarity and guidance should be given as to how the Basel II definition of default is interpreted in practice, as this appears to be one of the significant drivers of RWA variability.

Application to non-bank financial institutions

In accordance with paragraph 19 of Annex 1 of the consultative document, exposures to securities firms and other financial institutions will only be treated as exposures to banks provided these firms are subject to prudential and supervisory arrangements equivalent to those applied to banks and the risk drivers are publicly disclosed. The condition that the risk drivers must be publicly disclosed would most likely mean that many securities firms and other financial institutions would be treated as "corporate exposures". This specific condition should be dropped and instead, the recommended treatment below for bank exposures should apply.

Incorporating country risk

With regard to the question of whether it would be appropriate to incorporate country risk as an additional risk driver, while we agree that country risk should be considered (especially where transfer risk is present), it is difficult to imagine how this would be done in the proposed approach. We note that country risk, along with other risk factors, is already taken into account in a bank's external rating, making such a rating a simpler and superior risk indicator than the proposed two risk-driver approach.

Recommendations

Given all the issues outlined above and the fact that bank ratings did not really suffer from the same weaknesses as ratings on structured notes and sovereigns, we suggest that the external ratings-based approach be retained for bank exposures. For unrated banks or where ratings are not allowed, appropriate risk drivers could be used in combination with the current Basel II Option 1 approach for bank exposures, i.e. bank risk weight should be at least one-notch higher than the risk weight of the sovereign (based on the risk weights that would result from the sovereign risk review that the BCBS is undertaking). Moreover, the same general rule under Basel II on the use of foreign currency and domestic currency ratings should still apply, i.e. use international/foreign currency rating for exposures in foreign currency and domestic/local currency rating, if separate, for exposures in the domestic currency.

For banks that are not subject to or have not yet implemented Basel III, specific parameters should be defined in order not to unduly penalize such banks. For example, capital requirements calculated under the applicable prudential regulations could be used in addition to other risk drivers.

Short-term bank exposures

The 20% reduction in risk-weights for short-term interbank claims is being proposed to avoid a negative impact on market liquidity in interbank markets. However, it needs to be viewed in the context of the current risk weight of 20% for short-term interbank claims on investment grade or unrated counterparties (under the current Option 2 for bank exposures).

The proposal leads to significant increases in risk-weights for short-term interbank claims and needs re-evaluation in light of the overall objective of the Committee not to increase RWAs. In our view, the proposal lacks an explanation for the proposed increase in risk weights and an evaluation of potential unintended consequences on interbank funding markets and the associated liquidity risks.

In combination with the proposed risk weight of 300%, the proposals for short-term interbank claims could potentially significantly increase risk-weights for exposures to banks during times of financial stress. The consequence could be that banks might under a stress scenario even be more reluctant to lend to each other than they were during the 2007/2008 financial crisis

Any preferential risk weights for short-term interbank claims with original maturities of three months and less should also be available even if such claims are rolled over. This is necessary to retain risk sensitivity as otherwise the risk weight of a 10-year bond will be equivalent to the risk weight of an overnight deposit that is rolled over on a daily basis but could be recalled should credit spreads of the depository bank widen.

Evidence of deposits being rolled does not mean that the associated credit risks would be equivalent to long-term lending. This is consistent with regulatory liquidity standards where banks under the non-stressed net stable funding ratio (NSFR) regime do not obtain any long-term available stable funding (ASF) credit for deposits that are usually rolled.

If the BCBS intended to keep the requirement that "short-term claims cannot be expected to be rolled over" then the BCBS should clarify the term "expected to be rolled over" since a significant portion of short-term claims are usually rolled over and would only be recalled if the liquidity was required for other purposes. This pattern should in our view still allow banks to apply the preferential treatment of short-term interbank claims and as such, the term "expected to be rolled over" should be deleted or redefined. In the absence of that, a perverse incentive would have been created for banks to move short-term liquidity around to optimise the applicable risk weights.

In addition, if the BCBS believes that short term claims in general carry lower risk than long term claims, then it would be an inconsistent treatment to not extend this logic to banks attracting relatively higher risk weights.

3. Corporate exposures

Concerns about the proposals

The proposals in the consultation document are too simplistic and assume that all corporates across jurisdictions and across industries can be assessed using only one set of metrics. Moreover, the definition of corporate exposures is quite broad and includes a disparate group of entities (including trusts, funds, insurance, small businesses, etc.). The corporate exposure category is de facto the residual category in which all exposures not belonging to other categories are included. As such, the proposed risk drivers may not be meaningful or even not available for certain entities (e.g. non-bank financial institutions, insurance, funds, religious entities, etc.). The current proposal would potentially lead to a maximum risk weight for these counterparties, which is not risk sensitive.

In particular, the proposed framework is not adapted to insurance companies whose leverage ratio (before including off-balance sheet exposures) will always be above 5, and thus will not differentiate their risks. As an illustration, Aviva, AXA and AIG show a leverage ratio of 25, 13, and 5, respectively, while corresponding ratings are A+/A1, A+/Aa3, and A-/Baa3, respectively.⁶

The assigned risk weights for corporate exposures appear to be quite punitive. We observe, for example, that the risk weight for highly-rated corporates (AA or higher) will triple (from 20% to 60%). We understand from the meeting with the TFSA that this is because the selected risk drivers do not have sufficient discriminative power to distinguish between high quality corporates. We urge the BCBS to undertake further work in this area.

We especially do not agree with the use of absolute revenue as a risk driver. It is not necessarily reflective of risk and only unduly disadvantages smaller corporates, which is in contrast to the more preferential treatment extended to SMEs under the IRB approach (by way of the size adjustment to the IRB correlation metric⁷). This proposed treatment also disregards the fact that most exposures to smaller corporates are highly collateralized relative to exposures to large corporates. As such, we believe it is worthwhile to consider a separate treatment for SMEs to better reflect characteristics of SME exposures.

The TFSA mentioned at the Frankfurt meeting that SMEs, on average, have higher risk weights under the IRB than larger corporates. This could be due to the fact that large companies are, on average, in better financial shape than small ones. In other words, the univariate correlation between size and risk may stem from the fact that size is a summary of several other risk drivers, such as financial strength, profitability, access to funding sources, diversification, etc. However, when another risk driver is added to size, we should be careful to account for the correlation between risk drivers or we risk double counting the effects (e.g. in the current BCBS proposal, a smaller company may be penalized one time because it is small and a second time because it has a high leverage ratio).

The use of absolute revenue as a risk driver also raises the concern about potential volatility of the capital ratios due to exchange rate variations. The proposals fix the absolute revenue metric in Euro terms. Hence, if there are fluctuations in the exchange rate between the reporting currency of a non-Euro bank and the Euro, it could potentially lead to fluctuations in capital requirements.

The QIS template includes EBITDA as an alternative to revenue. However, we believe EBITDA's main drawback is the difficulty in achieving consistent calculation across jurisdictions. It is also an inherently pro-cyclical measure and has a size bias that is undesirable.

On the use of leverage as a risk driver, while leverage is clearly a primary risk differentiator, the proposed definition fails to recognize differences between accounting standards and business models seen in different industries (as alluded to above). Moreover, lower risk weights should be given to exposures to corporates with very low leverage. In the consultation document, where leverage is defined as Total Asset/Total Equity, the same risk weight is given to corporates with leverage in the 1-3x range. This means that a \$100 asset firm with \$66 debt is given the same risk weight as an otherwise identical

⁶ Base on their consolidated financial statements of 12/2013.

⁷ Paragraphs 273-274 of the BCBS document on *International Convergence of Capital Measurement and Capital Standards*, June 2006

“corporate” with no debt at all, such as a mutual fund. Hence, there should be more granularity in risk weight buckets for the lowest leverage ratios.

On the question of whether to incorporate off-balance sheet exposures in the leverage measure, we are of the view that incorporating off-balance sheet exposures would make leverage more meaningful but to be consistent, risk mitigating factors such as received guarantees or unused loan facilities should also be added. We recognize, however, that this would make the corporate exposure treatment more complex and highlight again the inherent difficulty of trying to reconcile the objectives of increased risk sensitivity and complexity.

Implementation of the proposed risk drivers

In many developing countries smaller businesses are not obliged to publish financial statements and thresholds for publication are relatively high. This could mean that de facto corporate risk weights for a substantial part of the overall corporate population would triple. This not only affects banks but equally may have an impact on the access to, and cost of finance for small businesses; this could be a fundamental obstacle for economic growth.

In many instances, the counterparty that a bank faces is not a parent company but rather a subsidiary of a parent company. The subsidiary will not typically have leverage and revenue data available. In these instances, the consultation would require banks to apply the very punitive risk weight of 300%, which we think is unreasonable. We propose that in this case the parent company’s ratios be used instead, which is the same as the approach being proposed for bank exposures.

Recommendations

We believe that, as future work after the initial SA changes, the corporate exposure category can be made more granular by defining subgroups of corporate exposures and identifying and calibrating a set of risk drivers for each subgroup (the risk drivers should not be limited to leverage and revenue but other risk drivers such as, for example, maturity, should also be explored for the distinct types of corporate exposures). For example, the rules for both equity and debt (credit spread) under the proposed new market risk SA delineate between industry sector. A similar approach should be considered for credit risk SA. If that level of granularity is prudentially required for market risk, it should at the minimum be also required for credit risk which is the more dominant source of RWAs for most banks. At the least, differentiated treatment should be developed for funds, insurance companies, broker-dealers, securities firms and other entities where the proposed risk drivers are clearly not meaningful or are difficult to define. A specific treatment for SMEs should also be considered given the different nature and risk profile of smaller firms.

As we stated above, we propose that external ratings, where available, be used as a starting point in determining the risk weights for corporate exposures but complemented by other risk drivers. If the other risk drivers clearly show evidence that the risk weights corresponding to the external ratings are not justified, then adjustments should be made. Where external ratings are not available (e.g. SMEs) or allowed, a fallback approach should be used. This fallback approach, for example, may allow the use of banks’ assessments of whether or not a counterparty is investment grade and assign risk weights accordingly. Such assessments should use clear and transparent criteria for rating exposures as

investment grade or non-investment grade, etc. The criteria could include appropriate risk drivers and should be made pursuant to a bank's transparent and supervised master rating scale (i.e., used consistently for all its borrowers and mapping to external ratings). The assessment criteria should provide evidence that the counterparty (or protection provider) has an adequate capacity to meet its financial obligations for it to be considered as investment grade. This means that the risk of counterparty default is low and the full and timely repayment of principal and interest is expected.

Subordinated debt and equities

For subordinated debt, we propose that instead of the proposed uniform 250% risk weight, an add-on to the risk weight assigned to the senior exposure should be introduced (similar to the use of a 75% instead of 45% loss given default (LGD) under the foundation IRB). This way, there is differentiation of treatment based on the credit quality of the subordinated debt issuer.

The same treatment should apply as well to equity exposures but with a higher add-on than that for subordinated debt (or preferred shares) in recognition of the fact that equity is a first loss position in the event of default (e.g. it could be twice the risk weight of the senior debt, the same way that LGD for equity (90%) is twice as high as that for senior debt (45%) under the Foundation IRB (FIRB)). For both subordinated debt and equities, the risk weight should be capped at the IRB simple risk weight approach for equity (i.e. 300%/400%). We believe that a uniform 300% and 400% risk weights are just too punitive and do not really reflect the actual risk. If more risk sensitivity can be achieved in a simple manner, this should be pursued.

At the least, the Basel Committee should consider retaining the current treatment for public and private equities as defined in paragraph 352 of Basel II. For some banks, investments in such equities are part of long-term customer relationships and should at least be treated depending on the credit quality of their issuers.

In general, the corporate risk weights should reflect the rank ordering of risk, i.e. (1) Senior debt, (2) Subordinated debt, (3) Equity.

Specialized lending

For specialized lending, the proposals would have severe implications on infrastructure financing in some jurisdictions, particularly in emerging markets. In particular, the proposal to use the maximum of the corporate risk weight or the specialized lending risk weight may be irrelevant in cases where credit is granted to a poor quality special purpose entity (SPE) based on the quality of the pledged asset. As mentioned in paragraph 21 of Annex 1 of the consultation document, specialized lending exposure is typically to a SPE. This is for legal isolation and bankruptcy-remote purposes. Hence, appropriate treatment of SPEs should be clarified, as treatment of SPE as a corporate appears inappropriate and may result in a 300% risk weight.

The consultation document states that a simple treatment for specialized lending is being proposed because it "constitutes only a small part" of the business of banks applying credit risk SA (section 2.2.2). However, the proposed credit risk SA is also relevant for large banks with large specialized lending portfolio because it is being proposed as a basis for a floor on capital requirements

resulting from the IRB approach. Hence, the proposed simple treatment of specialized lending would have huge implications for these banks as well. Moreover, the proposed simple treatment does not address the concern expressed in section 1.2, page 4, that the current SA is not sufficiently risk sensitive as a basis for a floor on IRB.

Hence, we believe it is not appropriate to just settle for a simple treatment of specialized lending given its importance to the real economy. More risk sensitivity should be sought where it is necessary and could be achieved in a relatively simple manner. In this regard, we propose that the slotting approach under the IRB should be considered for credit risk SA to make the treatment of specialized lending more risk sensitive, rather than assign a uniform risk weight that does not reflect actual risks. While the existing IRB slotting approach depends on internal assessments, appropriate regulatory guidance can be developed to harmonize such assessments.

Another idea would be to split specialized lending into phases (e.g. pre-operational or construction phase where there is no positive cashflow, and operational phase where positive cashflows are more certain) and assign risk weights depending on the risk of each phase.

At the least, the BCBS should consider applying differentiated treatment to specialized lending. Specialized lending includes a broad range of financing types, such as Commodity Finance, Project Finance, Object Finance, and Commercial Real Estate Finance, all with their specific characteristics and risk profiles.

Secured lending

We understand that the credit risk SA since Basel I has not recognized physical collateral (except real estate) for regulatory capital purposes because it has always emphasized simplicity. The new credit risk SA proposals, however, aim to reflect a reasonable extent of riskiness of exposures (objective ii under Section 1.1) and increase comparability of capital requirements under SA and IRB (objective iii). In this regard, we believe the new credit risk SA can achieve both objectives without resulting in undue complexity by recognizing credit risk mitigation to corporate exposures to the extent they are secured by non-financial collateral types that do not qualify as specialized lending – for example capital goods such as transportation, industrial, agricultural or office equipment that are secondary to the servicing of the loan – and yet substantially increase prospects of recovery in case of default. Various studies have been conducted illustrating the positive effects of such collateral.⁸ These collateral types are already recognized under IRB. Hence, recognizing the same under SA would achieve the objective to align more closely the SA and IRB approach. We believe appropriate and simple adjustments can be made on the proposed framework to reflect the risk mitigating effect of these collateral types (e.g. by adjusting downwards the corporate risk weights).

4. Retail portfolio

The use of the 0.2% diversification criterion raises the question we have in the general comments as to what kind of bank the framework is calibrated to. We believe this criterion requires more investigation, including whether or not the current approach of providing discretion to national supervisors is necessary.

⁸ See for instance Deloitte 2014 “The Risk Profile of Leasing in Europe: The Role of the Leased Asset”

While the 75% risk weight may be a good starting point for qualifying retail portfolios, the BCBS should also consider the risk mitigating arrangements included in certain retail transactions, e.g. loans paid by receivables (e.g. commercial, service and credit card receivables, payroll payments, rents, long-term public concessions), or collateralized by durable goods (e.g. vehicles) that meet specific requirements (see also secured lending above). We believe it is necessary to reduce the risk weight on non-residential real estate retail exposures to the extent they are covered by collateral at inception.

Exposures to small businesses where personal guarantees are given or where the revenue is not more than 10 million EUR at origination should qualify as part of the regulatory retail portfolio. Moreover, the size factor for SMEs should be set at an appropriate level so as not to put at a disadvantage this important part of the economy. We recommend that it should be updated and increased from 1 million EUR to e.g. 2 million EUR.

The BCBS should also consider introducing retail exposure sub-classes similar to the IRB to better align the two approaches, i.e. Retail SME, Qualifying Revolving Retail Exposures, Other Retail Exposures.

Moreover, we do not understand how the BCBS intends to introduce the risk weight add-on for currency mismatch at the individual exposure level, when retail exposures are risk weighted at a portfolio level. We are concerned that this would only lead to unnecessary complexity in the framework. In addition, while we understand that this proposed add-on may be intended for jurisdictions where it is widespread practice for banks to lend in foreign currency to their retail customers, this could also capture lending to high net worth individuals with income and borrowing in multiple currencies. It can be argued that these individuals are better positioned to understand and manage such risks and applying a flat risk weight add-on would be inappropriate.

5. Exposures secured by residential real estate

Concerns about the proposed approach

The two risk drivers proposed for exposures secured by residential real estate – loan-to-value (LTV) and debt service coverage (DSC) ratio – can be quite challenging to implement and interpret across jurisdictions. As recognized in the consultation document, different tax regimes can make it difficult to define the concept of “available income” and hence it would have implications on the use of the DSC ratio. In addition, the consultation document also recognized that “differences in real estate markets, as well as different underwriting practices and regulations across jurisdictions make it difficult to define thresholds for the proposed risk drivers that are meaningful in all countries”. We are concerned that if the credit risk SA becomes binding via floors, lower risk real estate markets will be dramatically affected when the SA is calibrated to an international average or lowest common denominator.

The issues identified in the consultation document clearly show that making a one-size-fits-all approach more risk sensitive has its limits and may only lead to unintended consequences especially in the case of residential real estate markets that are characterized more by domestic specificities. The introduction of risk drivers, especially when calibrated uniformly across jurisdictions, may only lead to operational complexity without necessarily leading to appropriate risk sensitivity.

We are particularly concerned about the use of DSC ratio as a risk driver because it will unlikely lead to comparable capital requirements across jurisdictions. The use of DSC calculated at origination is not risk sensitive, especially for long-term real estate loans where significant changes to the borrower's risk profile could occur during the life of the loan. The DSC is also not as relevant for mortgages when the mortgagor does not provide a personal covenant to pay and can walk away. On the other hand, calculating the DSC ratio on a regular basis presents not only operational challenges but also privacy issues, since it would require the bank to constantly ask the borrower for updated income and debt information. These issues should be considered by the BCBS in deciding on whether or not to use the DSC ratio. Other issues with regard to DSC include: (1) there is no common definition, which complicates a cross-country evaluation; (2) difficulty in determining income for certain borrowers (e.g. self-employed); and (3) quality and reliability of data may not be consistent.

In terms of the proposed risk weights, we feel they are quite linear and lack sufficient granularity, particularly at the lower LTV range, i.e. a single risk weight for all LTVs below 40% seems overly blunt and conservative (e.g. is a 5% LTV really as risky as a 39% LTV mortgage?).

The proposal to apply flat risk weights to the full exposure (i.e. no tranching of the exposure across different LTV buckets) combined with the proposed risk weights could significantly increase RWAs for first time buyers with high LTV mortgages. This could have indirect implications for national government schemes in some jurisdictions that encourage home ownership, and could lead to a greater burden on these schemes to bridge the LTV/lending gap in order to support first time buyer purchases.

We also disagree with the proposal that exposures where the risk of loan repayment is materially dependent on the performance of, or income generated by, the property securing the mortgage should not qualify as exposures secured on residential real estate. In the UK market, for example, Buy to let properties are collateralized in the same way as mainstream residential mortgages and the risk profile is similar. In other jurisdictions, risks associated with individuals purchasing a property for the purpose of rental may in fact be lower as the individuals tend to have other assets and sources of income which are subject to recourse. Therefore, where the competent authorities have evidence that a well-developed and long-established residential real estate rental market is present in their territory with loss rates comparable to (or lower than) residential real estate acquired and mortgaged for personal use, such exposures should be treated as secured by residential real estate.

We are also concerned about the condition that will have to be met before applying the national discretion to include unfinished properties in the treatment of residential real estate, i.e. that the loan is for a one to four family residential housing unit. The condition is subject to interpretation and discriminates against practices in other jurisdictions (e.g. Asia and other developing economies) where it is common for multi-tier families to reside in the same residence.

Recommendation

As illustrated above, the residential real estate markets are characterized more by domestic specificities including the existing legal framework in each market. The objective of the BCBS should be to reflect some risk sensitivity into the framework given these constraints. These constraints make uniform calibration of metrics undesirable since this would not meaningfully reflect actual risks in each

market. We believe the TFSA already recognized this issue and are looking for ways to address it. In this regard, we would like to formally propose the idea that was already raised at the Frankfurt meeting, which is to use a global metric (in this case, LTV) but calibrated based on objective, transparent, and fact-based national realities.

Pursuing this idea would require the BCBS to define a clear and transparent framework to calibrate and assign risk weights to the LTV measure based on national data. This would be akin to the methodology for the countercyclical capital buffer. Some factors that we propose to be considered in this framework include:

1. House price volatility in a jurisdiction over a number of years;
2. Presence or absence of national guarantee schemes;
3. The extent loans are recourse or non-recourse.

This framework for national calibration should be subject to disclosure requirements so that market participants, investors and supervisors are able to compare outcomes.

As opposed to a uniform calibration that only results in an appearance of comparability, we believe our proposal satisfies the comparability principle better since risks are appropriately reflected in the capital requirements thus resulting in more consistent outcomes. We offer our support to the TFSA in further defining such a framework for national calibration and in identifying factors that need to be considered.

Moreover, we recommend that the BCBS clarify that if exposures secured by real estate have additional collateral/guarantee recognized under credit risk SA, the additional collateral/guarantee should be reflected in the risk weight (e.g. risk weight of the guarantor should be used instead of the risk weight of the borrower). This is relevant because often banks grant higher LTV loans for the very reason that other mitigating factors (e.g. Lenders Mortgage Insurance, mutual insurance, parent guarantees, financial collateral) are in place. While this seems to be captured in the general principle for applying CRM, there is no explicit statement in the proposed rules text to this effect.

We also suggest that the BCBS consider applying grandfathering treatment to existing loans given the long-term nature of the product and capital/pricing environment at the time of origination. This will mitigate impact on existing customers.

6. Exposures secured by commercial real estate

We believe that collateral should be taken into account in determining the appropriate risk weight for exposures secured by commercial real estate. As such, at first glance, Option B would appear to be preferable. However, the ranges of risk weights are quite similar whether or not the exposure is considered as unsecured (60% to 130%⁹) or secured (75% to 120%). In fact, the lowest risk weight for an exposure considered as unsecured is lower than that for an exposure considered as secured. This is not consistent with a risk sensitive approach. Hence, we suggest that the range of risk weights for Option B be adjusted. If the BCBS pursues Option A, the unsecured risk weights should be adjusted in recognition

⁹ The 300% risk weight is only for cases where the counterparty has negative equity or where the obligor has not provided its revenue and leverage data to the lending bank

of the risk mitigating effects of commercial real estate. This would introduce risk sensitivity without being overly complex.

The use of LTV ratio as a risk driver under Option B, however, presents some concerns. Similar to the issues identified above for residential real estate, differences in real estate markets, underwriting practices, tax laws, etc., make it difficult to define LTV thresholds that would be meaningful across jurisdictions for different types of commercial real estate properties.

The use of LTV as a risk driver for commercial real estate could also pose difficulties as banks may not calculate LTV at a facility level in wholesale banking. Rather, banks would consider baskets of multiple collateral instruments (which may include real estate) securing customer group's multiple facilities under "all monies" clauses in collateral documentation. As such, we believe the IRB slotting approach for specialized lending could also be used for commercial real estate. This would reduce complexity and is consistent with the objective of aligning the SA and IRB. The LTV approach for commercial real estate would seem to be more relevant for SMEs where regular data would not be available to apply the two risk driver approach and/or the slotting approach.

There are also concerns about applying the RRE requirements to CRE. In particular, the "finished property" requirement was deemed counterproductive since vacant lot is perceived to be easier to dispose of during a crisis. There was also question as to how "finished property" is exactly defined in the context of CRE.

7. Credit risk mitigation

Use of internal estimates of exposures

The proposal to exclude the use of own estimates of haircuts, and VaR and IMM approach for exposures under the standardized approach would have important implications for banks that are under the standardized approach for credit risk but are approved by their supervisors to use advanced approaches (IMM or VaR) for exposure calculation of traded products. These are likely investment firms (securities traders) with very little lending business that would not justify investment in IRB. Hence, it would not be appropriate to force these banks to use the IRB approach just to retain their use of IMM or VaR.

The elimination of internal measures of exposure within the comprehensive approach could have material impact in terms of mitigation effect. It could also potentially reduce the incentive to continuously improve internal collateral management practices in terms both of data collection and risk management and measurement approaches. As such, we support maintaining the use of internal measures of exposure in the standardized approach framework.

Revised Haircuts and the Treatment of securities financing transactions

We are concerned with the increase in the supervisory collateral haircuts for equity-based transactions. The haircut for main index equity collateral has increased from 15% to 20% and the haircut for non-main index equity collateral has increased from 25% to 30%. The "comprehensive approach" to calculating the exposure for securities financing transactions is already highly risk-insensitive. This

approach does not account for diversification within the lending or collateral portfolios and also overlooks “flight to quality” during periods of financial market stress. Similarly, this approach does not recognize the correlation that exists between various loan-to-collateral pairs, assuming at all times that the market value of securities will move in opposite directions. In addition, the comprehensive approach assumes that the impact of foreign exchange movements is always negative. This problem is compounded by the very limited scope for the netting of transactions, meaning that the larger the portfolio of trades, the greater the overstatement of exposure. The extent to which banking organizations feel the impact of this issue will depend on the local implementation of the exemption for transactions with a “core market participant”, although we have already been advised that certain national jurisdictions do not favor this approach.

The increase in the supervisory haircuts will only compound the conservative and risk-insensitive approach to calculating exposures for equities and other securities financing transactions. The consultation document does not give justification as to why the haircuts have been recalibrated. The existing haircuts are already significantly more penal than the median market haircuts for tri-party repos.¹⁰

As such, we strongly recommend that the BCBS develop a new non-model based alternative for the measurement of exposures to SFTs. This is something that the BCBS signaled it would do in its final large exposure framework and we urge the establishment of a dedicated work stream to carry this important project forward. One alternative might be for regulators to provide all market assumptions and banks would only input portfolio data and run computations (Regulatory Input Method). Another alternative might be to preserve the comprehensive approach but introduce a multi-dimensional haircut matrix, which incorporates correlations, diversification and other key factors (Revised Comprehensive Approach). A third alternative could be to use the existing exposure measure for derivatives under SA-CCR but adjusted for SFTs (SA-CCR for SFTs). While these alternatives have been developed by some member banks and presented to various supervisory entities, notably in the context of work on the large exposure regime, they remain preliminary in nature. We are therefore happy to explore these and other similar alternatives with the BCBS as it works to refine the revised standardized approach.

Lastly, we are also concerned about the alternative collateral haircuts table that does not use public credit ratings as we deem it to be too narrow. Public sector entity (PSE) collateral with RW >100%, bank collateral with RW > 60%, and corporate collateral with RW > 80% is either not permitted or assigned the most punitive haircuts. Given that only “financial collateral” is allowed, the range of RWs should be expanded to include all PSE, bank, and corporate collateral.

Credit derivatives that do not include “Restructuring” as a credit event

The proposed new credit risk SA would no longer recognize credit derivatives that do not include “Restructuring” as a credit event. This would impact the US, in particular, where the standard credit derivative documentation does not include “restructuring” as a credit event. Under this proposed change, there will be no regulatory capital relief provided for US credit derivative No-Restructuring (NoR) contracts. It is unclear what the Basel Committee’s concern is but we believe discounting the full value of the protection is overly penal.

¹⁰ see for example the Federal Reserve Board’s statistical data for tri-party repos:
http://www.newyorkfed.org/banking/tpr_infr_reform_data.html

Generally, US companies use Chapter 11 bankruptcy in order to restructure their obligations. Therefore, there is no need to add "restructuring" (MR or MMR) as a credit event trigger in the US. Other jurisdictions around the world trade credit default contracts with restructuring language since bankruptcy laws in these locations do not provide a similar structure to the US Chapter 11 code. Therefore, restructuring events can occur without a corporate bankruptcy in other parts of the world and can trigger credit derivative contracts.

In addition, clearinghouses in the US only clear NoR credit derivative trades. There is currently not enough Modified restructuring (MR) volume in the US to allow these trades to clear (trades do not clear if there is not a minimum number of dealers to provide daily tradable bids and offers). Dealers will not begin trading MR contracts since they are unable to clear trades. If banks and clearinghouses were to start using MR contracts, they will have to manage the basis risk with legacy credit default swaps (CDS) that do not include restructuring, thereby introducing new risks into the financial system.

The exclusion of a restructuring clause has not diminished the function of US credit derivatives as effective risk hedges. Therefore, we do not see the rationale for excluding such credit derivatives from the list of "eligible financial collateral". Cleared NoR trades should continue to be viewed as an effective credit risk mitigation tool. Moreover, we believe the current 40% haircut that is applied to the amount of the credit derivative hedge if MR is not a stated credit event is not justified. This haircut was introduced in Basel II as a stop-gap measure and was not intended to be permanent.¹¹

We refer to the separate letter by IACPM for a more detailed discussion of this issue and the recommendation that US CDS contracts should receive 100% capital relief as opposed to 60%.

Securitization guarantee

Although the securitization framework has recently been finalized, the proposal suggests further changes to this framework by no longer allowing the recognition of corporate guarantors for these exposures. We do not think the SA approach for credit risk should be used to make further changes to the securitization framework. We are also unclear as to the rationale for the change in the first place and believe that it will only discourage hedging. We would thus welcome further explanation as to why the BCBS considers that they will "limit regulatory capital arbitrage" with this proposal. Insurance firms, hedge funds, pension funds, Freddie Mac and Fannie Mae are examples of securitization guarantors that may fall under the corporate category. The non-recognition of this protection would be a significant change. If the BCBS knows of certain structures or types of transactions that raise this kind of problem, we would like to know about them so we can consider and comment on whether there might be better ways to solve the problem.

While most guarantors of securitization exposures (at least those where the guarantees are unsecured) may be "sovereigns, PSEs, MDBs or prudentially regulated financial institutions", we see no reason why other types of guarantors should be excluded for securitization but not for other kinds of transactions. In fact, many guarantors of securitization exposures, or in transactions that create securitization exposures, are special purpose entities (SPEs) whose guarantees are supported by eligible collateral. We would like to confirm that, if the proposed exclusion of corporate guarantees is adopted,

¹¹ Footnote 55 of the BCBS document on *International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, June 2006

it will not affect the position that, although "SPEs cannot be recognized as eligible guarantors", "Collateral pledged by SPEs may be recognized" (BCBS 303 paragraph 99).

Also, it is not uncommon for securitization transactions to relate to underlying securitized assets that are themselves supported by guarantees, including corporate guarantees. We ask the BCBS to confirm and clarify that corporate guarantees of underlying securitized exposures, as opposed to guarantees of securitization positions, would still be given effect for purpose of calculating the capital requirements of the underlying assets and, indirectly, of the resulting securitization exposures.

In addition, the removal of corporate guarantors would cause further difficulty in the interpretation of the securitization boundary. The Basel definition of securitization, which focuses on recourse to a specific pool of assets and tranching, captures limited recourse lending where the borrower takes a first loss position. However, there may be solid legal reasons why the borrower may transfer assets to a bankruptcy remote vehicle (to protect the lender's interest) but to provide recourse to the lender. If the borrower is not judged to be an eligible guarantor, this transaction (a secured corporate borrowing) will become a securitization. We do not believe the securitization framework is intended to capture this circumstance. The resulting capital treatment under the securitization framework is often disproportionate to the risk the lender is taking.

What is not clear from the proposal to remove corporates as eligible guarantors is what the Committee intends should happen in these boundary cases. Would the presence of the guarantee still remove the exposure from the securitization framework or would this approach be disallowed and such exposures be forced to be treated under the securitization framework, with the consequent disproportionate capital treatment? Clarification on this point would be welcome.

References to external ratings in the CRM framework

We do not support the idea to remove the external credit rating requirement for eligible financial collateral, and the references to external credit ratings in the supervisory haircuts table. As the consultation document points, this is a "second-order" issue because references to external ratings in this context does not directly determine the risk weights. In addition, as pointed out above, external ratings are still used in the Basel securitization framework and in the proposed new market risk framework. So we think eliminating all references to external ratings in credit risk SA is not necessary. It will just lead to unnecessary complexity (e.g. how will supervisors ensure that "investment grade" will be consistently defined in practice?) without any clear benefits.

In addition, the implementation of the proposed alternative approach would create a disproportionate burden on banks focused on wealth management activities, where a large proportion of their lending portfolio is constituted of loans collateralized by financial assets ("Lombard lending") which predominantly use the comprehensive approach to credit risk mitigation.

1250% risk weight

The assumption of 8% as a minimum capital ratio and the corresponding use of the 1250% multiplier to transform an exposure amount to a risk weighted amount (RWA) is outdated (e.g. treatment of first- and second-to-default credit derivatives and materiality thresholds). The effective minimum

capital ratio is now much higher than 8% under Basel III. Thus, the continued use of the 1250% multiplier results in an overblown RWA that in turn translates into a capital requirement that is higher than the actual exposure.

We understand from the meeting with the TFSA that a separate group within the BCBS is already working on some proposals to address this issue. We very much welcome that information and we look forward to knowing more about this work and, if necessary, to providing industry inputs.

8. Off-balance sheet exposures

The consultation document proposes to increase significantly the capitalization of certain commitments, without providing objectives, rationale or substantiation of the proposed higher credit conversion factors (CCFs). We are concerned about the potential impacts to lending activity, especially if the credit risk SA becomes a binding capital constraint (dependent on how capital floors are implemented). Further downstream impacts to lending markets are likely if these CCFs will also be used in the Leverage Ratio (and by extension, the G-SIB surcharge framework) and the Large Exposures Framework. Proper calibration of CCFs for commitments is essential; we recommend that the Committee retain the existing CCFs until appropriate analysis can be done, including consideration of interdependencies with other frameworks. The analysis should include not only the appropriateness of the proposed changes to the CCFs, but also of the existing CCFs that are not proposed to be changed (i.e. CCFs for self-liquidating trade letters of credit and for certain transaction-related contingent items).

The proposal to increase from 0% to 10% of “Commitments that are unconditionally cancellable at any time without prior notice, or that effectively provide automatic cancellation due to deterioration in borrower’s creditworthiness” is unduly punishing such lending activity. Putting a cost on unconditionally cancelable commitments will require banks to charge for those commitments or to withdraw them, which will reduce the ease of payments and reduce economic activity when it has not been shown that banks are inadequately capitalized for the risks created by offering such commitments.

The IIF RWA Task Force (IRTF)¹² study shows that use and scope of the “unconditionally cancellable” category both in IRB and SA banks shows high degree of variance (e.g. whether mortgage offers are included or excluded). It is worthwhile examining further what are included and excluded under this category before determining the appropriate risk weight. For example, for some facilities (e.g. credit cards) the commitments can be withdrawn without the constraints the Basel Committee is suggesting in the consultation document. Hence, for these commitments, the 10% CCF is unduly punitive.

The consultation document cites that it is trying to align the credit risk SA and FIRB, but no reason is given as to why the 75% CCF under FIRB is more appropriate than the existing credit risk SA CCFs of 20% and 50%. We would thus propose that the 20% and 50% CCFs be retained until quantitative analysis is done to appropriately calibrate CCFs, as we believe historical drawdown rates are well below 75% and the combination of current levels of the CCF and the risk weight that will eventually be applied to any undrawn amount adequately captures the credit risk.

¹² IIF Risk-Weighted Assets Task Force (IRTF) Final Report, November 2014 (copy of which were circulated to regulators but also available upon request by the TFSA)

We note that the credit risk SA QIS collects information on advanced IRB (AIRB) banks' CCFs. Presumably, this would be used to compare with the proposed CCFs. We would like to stress, however, that the CCFs used by AIRB banks for regulatory capital purposes may reflect not just the historical drawdown rates that banks experience but also the conservatism desired by some supervisors. In the same IRTF report mentioned above, one of the findings is that there are a significant number of AIRB banks that use different CCFs for regulatory capital versus other (e.g. economic capital, provisioning) purposes, with the former being more conservative. Hence, adding more conservatism in the SA to what may already be a conservative measure in the AIRB will only result in a punitive treatment. This would also lead to more punitive treatment of high quality counterparties (which, on average, have low utilization rates) since conservatism are introduced on both SA risk weights and CCFs. A study of AIRB CCFs will also show that there are different ways of calibrating CCFs, usually taking into account the riskiness of the borrower and could incorporate other factors that reflect the way customers use their credit limits (e.g. Utilization-Income rate, transactor vs. revolver, etc.). The industry would be happy to discuss with the BCBS with the collective aim of establishing a simple, comparable approach to off-balance sheet exposures that is also risk sensitive and more closely aligned with IRB approaches.

9. Other assets

According to the proposal, the standard risk weight for all other assets will be 100%. Whereas cash as eligible financial collateral is explicitly mentioned and receives a 0% haircut, cash in hand and equivalent cash items that do not serve as financial collateral are not addressed accordingly in the "other asset" class. Therefore we strongly propose to include an explicit risk weight of 0% for cash in hand and equivalent cash items. In addition, gold bullion held in own vaults or on an allocated basis to the extent backed by bullion liabilities should be treated as cash and are therefore risk weighted at 0%. In addition, cash items in the process of collection should continue to be risk-weighted at 20%.