Nederlandse Vereniging van Banken

Date 26 March 2015

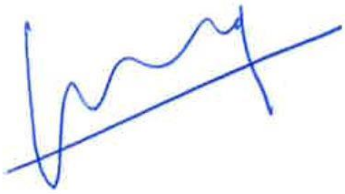
Reference NVB response to the Basel SA Revision consultation

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz2, CH-4002 Basel , Switzerland

Dear Sir/Madam,

We welcome the opportunity to provide feedback on the consultative document "**Revision to the Standardised Approach for credit risk"** and look forward to an on-going constructive engagement on this topic. Please note that we will submit a separate response document related to the Capital Floors consultation.

Sincerely,



Eelco Dubbeling
Managing Director
Dutch Banking Association

Some Dutch banks contributed to the response letters of IIF, IBfed, EAPB[1] and EBF; therefore to a large extent we underpin their responses. Next to these responses we also would like to emphasize on the Dutch context through this response letter.

We believe that any increases in risk sensitivity within the SA framework should be restricted to areas where it is possible to do so in a way that enhances the existing framework, and yields intuitive results. We hope that a collaborative and interactive consultation can be the first step in the process of identifying such areas.

This document also includes a Trade & Commodity Finance Annex, written in collaboration between the AMFE, FBF and NVB.

The remainder of this document is structured as

[1] EAPB = European Association of Public Banks

Nederlandse Vereniging van Banken

1. Executive Summary

1. We support the motivation behind the proposed changes to the Standardised Approach (SA) to attempt to increase risk sensitivity and reduce the gap between IRB and the Standardised Approach. We feel that differentiated risk weights for subordinated debt, unrated corporates and also for other exposure classes are much needed. However, we also stress the vast magnitude of this undertaking, which will have wide ranging impact on all exposure classes, and should therefore be based on well calibrated risk drivers with sufficient predictive power.

2. Such an increase in risk sensitivity must also work intuitively, by increasing RWA for more risky assets and vice versa, and we challenge whether the current proposal fully achieves this requirement. In particular:
   - There are risk drivers that offer better predictive power than revenue (e.g. profitability metrics) - revenue is typically only used to distinguish between large corporates and corporate SMEs given their different risk behaviours and correlations, and not as a driver in the model itself
   - A uniform increase in conservatism of the Risk Weights (RWs) for mortgages across all markets is not justified. There are structural differences that have resulted a range of mortgage loss severities experienced during the most recent crisis; these differences should be incorporated into the calibration
   - Where available, external ratings are typically better predictors of default rate than simple single or dual factor approaches, and easier to implement

3. When adding risk drivers, this is essentially the creation of a model, and as such should be periodically tested to ensure the calibration is set at a reasonable level, and the areas most impacted are intuitive when comparing across jurisdictions. However, in this respect, we argue that the current proposal has several unintuitive outcomes
   - Markets that showed limited impact on credit in the last downturn were forced to increase capital requirements, whereas countries which still have not addressed structural issues will be largely unaffected
   - The gap between IRB and Standardised Approach risk weights would increase under the current proposal, contrary to the goal of alignment (please see Figure 3 for the estimated impact by counterparty type for Dutch banks)[2]
   - The impact and calibration must consider the range of business models that exist. Based on the current proposal, the impact will be most severe for banks specialising in residential mortgages

4. The proposed changes are also likely to create new distortions that may be greater in magnitude and more malign than what already exists
   - There may be a stronger incentive to push into higher risk residential mortgage segments in low risk markets, and in general, low risk business models my face severe pressure

[2] This point is discussed further in our response to the Capital Floors consultation

- The capital requirements for emerging markets banks at the top of the cycle, or other high risk entities with a banking license (e.g. certain Private Equity funds or hedge funds), with high capital ratios that are not comparable to other markets, will decrease
- There may be a shift in portfolio composition towards less well designed (seniority, cover and collateral) structured finance deals (e.g. benefits of covenants etc.) in light of higher yield without a corresponding increase in capital requirements

5. The implementation of the proposals as written would also have material public policy implications
   - Please refer to our response to the Capital Floors consultation, where we calculate that the potential impact could be a 45% - 60% reduction in available capital ratios for Dutch banks
   - We expect there would be a significant squeeze on available capital, reducing lending to SMEs particularly, with an impact on economic growth and job creation
   - We expect lending to first-time home owners would be squeezed due to the DSCR threshold
   - We also expect that this would accelerate a shift to shadow banking, which will exacerbate conduct and other regulatory concerns related to more lightly regulated entities, and also weaken the effectiveness of macro-prudential tools
   - The current Solvency regulations for mortgages loans differs from the Basel regulations. This results in lower capital allocation for Solvency regulated companies in case of similar risk profiles related to residential mortgages. This proposal would widen the gap. We urge the BCBS to ensure a level playing field when revising the SA framework.

6. Elements of the proposals will also be difficult for banks to implement, and these should be considered seriously. At a minimum, well specified guidance, sufficient timelines and appropriate phase-in of any new rules are required. We also propose that the BCBS investigates introducing a prudent “simple approach” for domestic banks which is similar to the current approach. Within which, prudent, but not unduly conservative, fall-backs can be used in cases when data is not available or implementation of a risk sensitive “core approach” is too burdensome. Examples of implementation challenges are:
   - Wide scale data capture of revenue data for corporates would be required
   - CET1% and Net NPE levels would need to be systematically captured in systems
   - DSCR and LTV would need to be consistently calculated to harmonize across different tax jurisdictions and calculation/valuation approaches
   - Material changes would need to be made to RWA calculation engines

7. We believe that there are simple alternatives to the proposals that better meet the objectives of BIS, are easier for banks to implement, and will result in fewer distortions
   - **For corporates:** we request that the BCBS introduces a Corporate SME category in order to more fully align to the IRB approach, and we also urge the BCBS to take this opportunity to consider the greater diversification/lower concentrations, and collateral benefits (including insurance schemes, lowering the risk profiles of SME clients), characteristics of this risk class –in a local calibration similar to that proposed for mortgages. We also propose to retain external rating as part of the SA, and for the BCBS to investigate alternatives to revenue (such as profitability)

- **For residential mortgages**: a centrally determined local calibration is required in order to differentiate between markets. There are clear structural reasons why some mortgage markets are less risky than others (e.g. legislation that permits timely foreclosure and recovery in the Netherlands) which should be factored into the calibration. This will ensure an intuitive relationship between risk weights and the underlying risk itself, when reading across markets. Further, we argue that Debt Service Coverage Ratio (DSCR) has limited power as a risk driver, and alternatives should be explored. We propose two options in Section 4.3 that could be built upon incorporating these points
- **For banks:** given external ratings are very often available for financial institutions, and incorporate a broader information set than any simple factor based approach, we do not see a need to move away from using external ratings. Those banks without ratings are precisely those for which the relationship between CET1 and Net NPA with risk breaks down given they are typically in markets which have not implemented Basel III, nor harmonized NPE definitions

8. Finally, it is essential that the QIS process not only assesses impact (in which the current calibration appears conservative), but also shares the underlying results which support the assertions that are made in the consultation document. We also urge the BCBS to consider alternative, potentially more effective and simpler, approaches. For this purpose we kindly suggest that the BCBS discloses the differentiating power for the risk drivers against observed losses, including for those factors not proposed but which were also considered.

Nederlandse Vereniging van Banken

2. Banks

This section details the supporting analysis and views relating to the banks proposal (cf. Section 2.1 of the consultation paper). The section is split into three sub-sections,

- **Overarching issues with the current proposal**: the first subsection provides our analysis highlighting our perceived issues with the current proposal
- **Assessment of proposed risk drivers:** the second assesses the specific risk drivers as proposed
- **Alternative proposals:** The third outlines an alternative proposal for the Standardised Approach for the consideration of the BCBS, in order to address those issues identified

This section address questions 1–4 of the consultation.

The three subsections are laid out in turn below.

2.1. Overarching issues with the current proposal

While, in principle, we agree that institutions should never systemically rely on external ratings, we argue against the proposal to completely remove external ratings from the Standardised Approach for banks. We argue that the risk of any such over reliance can be monitored and mitigated through other areas of the supervisory framework – in particular ICAAP / SREP.

- We acknowledge that in the recent crisis there were several cases in which external rating agencies did not correctly assess or did not timely adjust their risk assessment. However, to our best knowledge these cases were largely concentrated in a single exposure class (securitisations) in a single jurisdiction
- Since the crisis external rating agencies improved their processes. The regulations around it were strengthened in the areas of independence and management of conflict of interest, transparency of rating disclosures, quality of rating process, treatment of confidential information and internal controls/CRA accountability (e.g. CRA1 to CRA3 in a European context).
- And, importantly, external ratings are often based on much more information than the two risk drivers that the BCBS proposes, and often include these risk drivers. Therefore we argue that external ratings (excluding sovereign support) are typically a more accurate reflection of the actual risk. Hence, removal of external ratings would lead to less risk sensitivity.
- There is a new cliff effect introduced by the proposal for banks that report a low CET1% that would not be able to receive financing given the chance of jumping to a 300% risk weight. Further, the overall calibration seems to be significantly more conservative, and this requires long consideration and discussion as part of the QIS

2.2. Assessment of proposed risk drivers

In this section we provide our assessment of the proposed risk drivers in turn (cf. Q1 and Q2).

We have conducted analyses to assess the predictive power of external ratings (both Long Term, and Bank-Stand-Alone ratings which ignore sovereign support), Tier 1 capital (due to the unavailability of CET1 capital in historical data), and Net NPL ratio (due to issues relating to obtaining data for impaired, and impairments on, debt securities), using public source data from

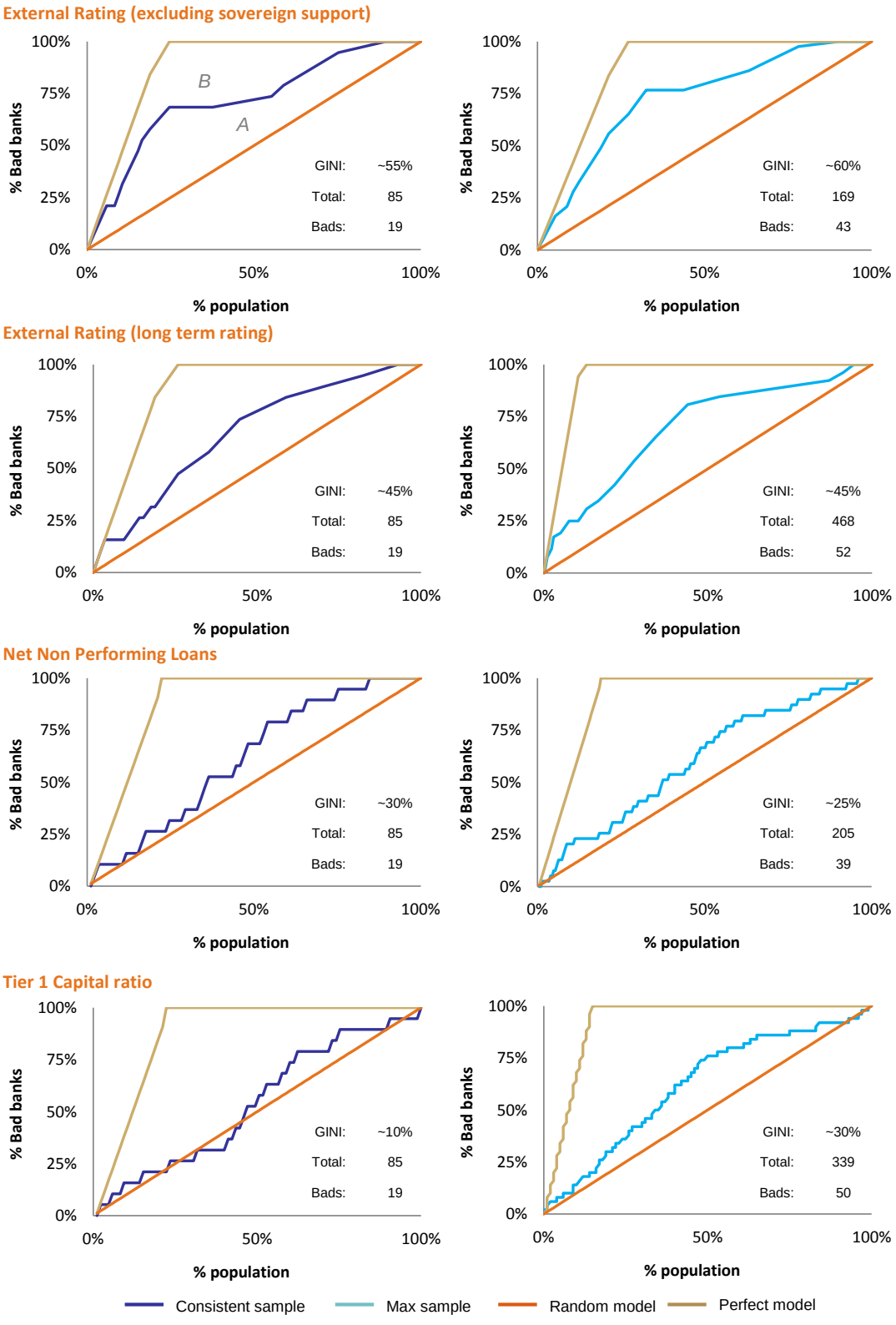
SNL, Bankscope, DG Competition, Bloomberg, Moody's, S&P and Fitch. The "bad" banks are those which have either defaulted, or have received state aid (with a DG Competition case-number) during the period 2009 - 2013. The analysis uses metrics as of year-end 2008, taking a single snap-shot to minimize survivorship bias. The population comprises 85 banks, of which 19 defaulted or received state aid following the crisis.

The charts below show the population of banks ranked by each metric, and the GINI coefficient is calculated as area A divided by area A + B (see Figure 1) ; in general the higher the coefficient the stronger the metric is as risk driver. Based on this analysis, the metrics in order of predictive power are:

1. External Rating (excluding sovereign support)
2. External Rating
3. Net NPL
3. Tier 1 capital ratio

Note that there is limited data availability for this analysis which can be used to test and calibrate factors. This is due to a number of reasons: the low number of bank defaults, and difficulties in defining a consistent "bad" definition across jurisdictions for state aid; the difficulty in obtaining all metrics for a given bank for a historical snapshot (for example impairments and NPEs are not consistently defined or reported historically); and different regulatory approaches historically (Basel I vs. Basel II vs. other). We have also performed the same analysis for each metric on the maximum sample available for that single metric for our snapshot. External Rating (excluding sovereign support) again demonstrates the largest predictive power, followed by External Rating, and then the BCBS proposed metrics. These results are also plotted in Figure 1.

Figure 1: Banks: predictive power by metric



Comments on the proposed risk drivers:

- **Common Equity Tier 1 capital:** CET1 has many flaws as a metric to read across banks and regions, which results in a limited predictive power;
  - **Pillar II**: there are a number of material items which are not in the RWA denominator of the capital ratio which can skew comparisons across banks, for example Interest Rate in the Banking Book is often a more material risk in emerging markets, which makes EM CET1 ratios appear higher per "unit of risk" relative to more advanced peers
  - **Differences in the denominator**: it is well known that there are a number of discrepancies across markets and banks, either in IRB model assumptions, National Discretions, or simply because some banks use the Standardised Approach vs. IRB, again making it hard to read across
  - **Differences in the numerator**: there are also a number of reasons why the numerators may not be comparable, to list a few: National Discretions (e.g. for phase in of prudential filters); National legislation which determines whether Deferred Tax Assets can be considered Deferred Tax Credits due to a state guarantee; provisioning methodology practices etc.
  - **Availability**: CET1 ratios are typically only available for the most advanced markets (where ratings are typically available), and there is very limited history of data with which to calibrate risk weights
  - **Re-calibration:** Use of this metric may require re-calibration as regulation changes impact the calculation of the ratio (e.g. the outcome of this consultation)
  - **Definition**: the exact definition of regulatory minimum would need to be well specified, for example to determine whether capital buffers are considered in a consistent manner, this would also have possible implications for data collection
  - **Pro-cyclicality:** Use of CET1 ratios is likely to introduce more pro-cyclicality than using ratings, where expert judgment can be used to overlay decisions, and ratings can be based on future expectations as well as current levels

- **Net Non-Performing Assets:** also has limited predictive power and we again identify key issues with this metric
  - **Definition:** Differences in the definition of "Non-performing", and impairment methodology mean that this metric is not straightforward to compare. These issues are likely to be most relevant for smaller banks for which not rating is available
  - **Collateral:** The net NPA metric does not capture differences in LGD between banks' assets, for example if two portfolios had the same NPL ratio with different levels of collateral, the higher collateral portfolio would (correctly) have a lower provision, and therefore higher Net NPA, however it is not clear that a higher RWA charge would be justified
  - **Re-calibration:** Use of this metric may require re-calibration as regulation changes impact the calculation of the ratio (e.g. harmonization of NPE definitions and the introduction of IFRS 9)

  Pro-cyclicality: Use of Net NPA ratio is likely to introduce more pro-cyclicality than using ratings, where expert judgment can be used to overlay decisions, and ratings can be based on future expectations as well as current levels

2.3. Alternative proposals

Proposal 2A: Continue to use external ratings, and consider the introduction of a maturity dimension

Our proposal is to use rating of the bank itself (i.e. somewhat similar to "Option 2" in the current Standardised Approach) where available. For majority of banks, counterparties without an external rating is a small proportion of exposure, and these are likely to be the banks for which the issues above are most pronounced (given these banks are most likely to be in those markets which do not comply with Basel III or harmonised NPE definitions), therefore a fall-back (which is not unduly conservative) single risk weight for unrated banks would be the best compromise between simplicity and prudence.

We also propose that the BCBS investigates adding a maturity dimension, in a similar way to the IRB approach's maturity adjustment (and in addition to the short-term adjustment), in order to add risk sensitivity in a simple way, in combination with the use of external ratings.

3. Corporates

This section details the supporting analysis and views relating to the corporates proposal (cf. Section 2.2 of the consultation paper). The section is again split into three sub-sections,

- **Overarching issues with the current proposal**: the first subsection provides our analysis highlighting our perceived issues with the current proposal
- **Assessment of proposed risk drivers:** the second assesses the specific risk drivers as proposed
- **Alternative proposals:** The third outlines an alternative proposal for the Standardised Approach for the consideration of the BCBS, in order to address those issues identified

This section address questions 5 – 8 of the consultation.

3.1. Overarching issues with the current proposal

We support the BCBS in their attempt to introduce more risk sensitivity into the corporate calibration. Given the unavailability of rating, an alternative could materially increase risk sensitivity, and we agree that leverage may be a useful key driver in this respect. However, we do see some challenges in the current proposal, in particular we urge the BCBS to strongly consider implementation as a considerable challenge for the corporate revision. We would strongly urge the BCBS to draft a prudent "simple approach" which can be easily implemented by less sophisticated banks. Such an approach is likely to be most fit for purpose if it continues with the existing methodology using external ratings only.

- While we agree revenue should be used to distinguish between large corporate, and corporate SME (given the different risk profiles of these two groups of counterparty), the use of revenue as a risk driver is a step to far given the relatively low predictive power. This approach is consistent with the view of the Dutch banks. We also see a strong need for a <[50]M Euro revenue, >[1]M Euro[3] exposure category where the strong diversification benefits are appropriately reflected through lower risk weights (and potentially this portfolio could also include a obligor concentration limit similarly to the retail portfolio)
- For the large rated corporate exposures, we argue that given the strong predicative power of external ratings (see Figure 9), the approach should still use this information where it is available. Where rating does not exist it is our view that the BCBS should investigate whether there are better alternatives to revenue
- We understand that the credit risk SA since Basel I has not recognized physical collateral (except real estate) because it has always emphasized simplicity. However, with the introduction of additional risk sensitivity, a crucial part of this is the additional collateral. For example, ranging from collateral with observable market values, to transportation, industrial, or office equipment that are secondary to the servicing of the loan -- and yet substantially increase prospects of recovery in case of default. Also including insurance schemes, lowering the risk profiles of SME clients. This could perhaps be accomplished using a set of local, centrally calibrated, haircuts.
- The calibration as it stands will result in a uniform increase in RWAs for Corporate SMEs globally, whereas there are clearly significant differences in performance across markets, we

[3] Example definition of Corporate SME following European IRB approach

suggest that the BCBS again looks to a local calibration in order to insure that the implications of any revision are intuitive across markets for Corporate SMEs

- implementation of this approach will require substantial data collection and changes to Risk Weight engines, time and appropriate phase in an absolute must in this regard
- We also consider that a single calibration across countries and industries may be "oversimplifying" differences in e.g. leverage ratios for similar eventual risk profiles, and may cause skews where specific industries suddenly become less attractive
- The statement "Empirical evidence shows that specialised lending generally exhibits higher risk and losses than other types of corporate lending" may be too broad a generalisation. Indeed, there is evidence that specific businesses are of a rather low risk nature. Trade finance and commodity finance are typical examples. Their short term, mostly uncommitted, collateralised and/or transactional nature allows banks to reduce exposure actively at an early stage in case of difficulties.

3.2. Assessment of proposed risk drivers

In this section we provide our assessment of the proposed risk drivers in turn (cf. Q5 and Q6).

We have conducted analysis to assess the predictive power of external ratings, leverage ratio, revenue, and profitability (net income), using public source data from Bloomberg, Moody's, S&P and Fitch. The data is based on externally rated corporates. The "bads" are those which defaulted during the period 2008 - 2013. The analysis uses metrics as of year-end 2007, in order to maximise available data, and takes a single snap-shot to minimize survivorship bias. The population comprises 1,545 corporates, of which 133 defaulted in the period following the crisis.

The charts below show the population of banks ranked by each metric, and the GINI coefficient is calculated as area A divided by area A + B (see Figure 2); in general the higher the coefficient the stronger the metric is as risk driver. Based on this analysis, the metrics in order of predictive power are:

1. Rating
2. Leverage ratio
2. The BCBS proposed RWs
2. Profitability
5. Revenue

The BCBS proposed bucketing approach assigns each corporate a RW using the leverage ratio and revenue look-up table proposed by BCBS in the consultation paper. This RW is used as the metric by which counterparties are ranked. The predictive power of this metric is very similar to leverage ratio stand-alone. Revenue is a much weaker predictor than the other metrics tested.

Note that this data is based on rated corporates, and therefore conclusions are not necessarily representative of corporate SMEs. However we have also consulted with the three largest Dutch banks regarding the factors used in their own internal models, and their assessment is broadly aligned to the analysis based on public data;

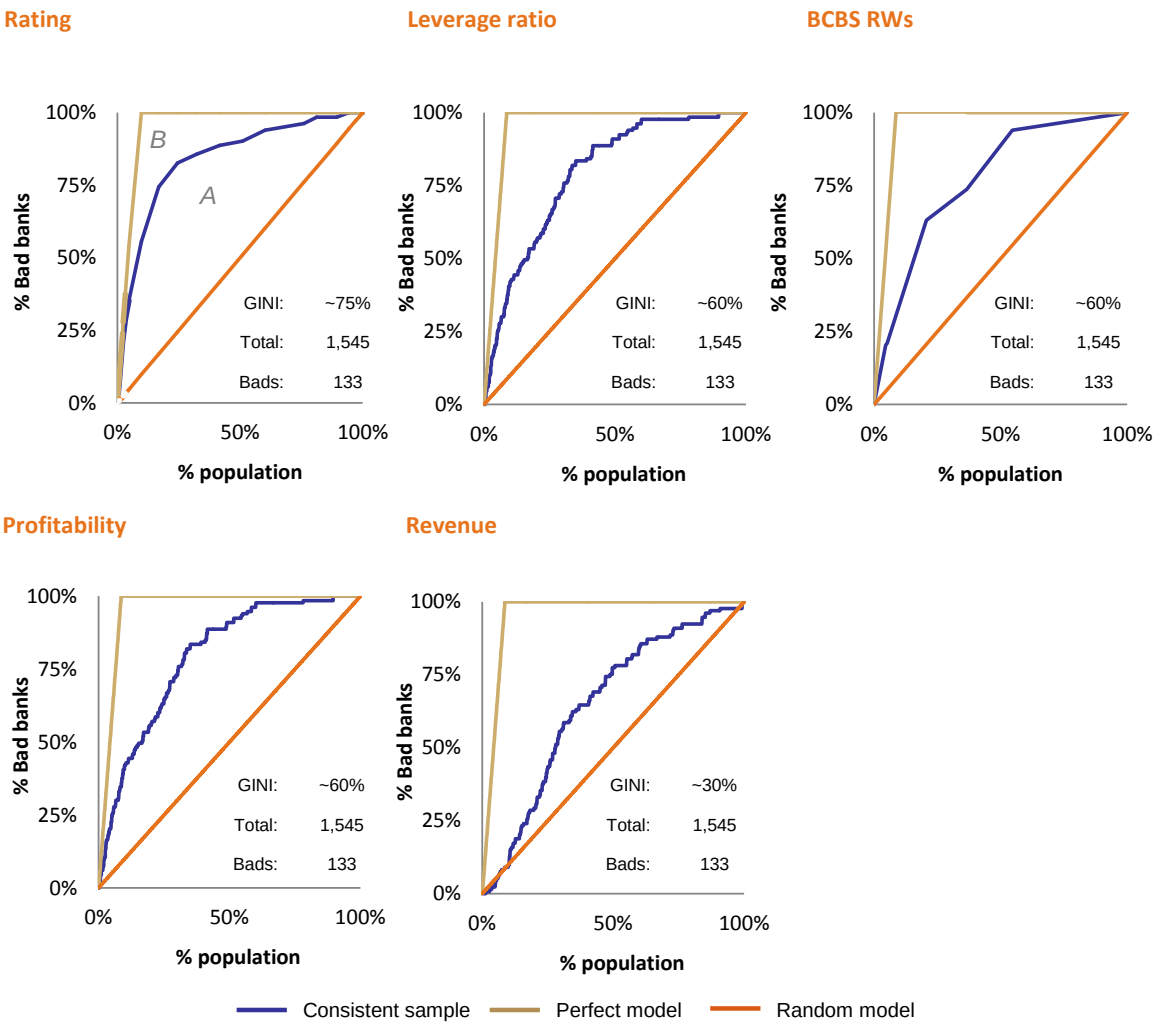
- None of the banks used revenue as a factor, and no bank found that revenue had a weight of more than 5% when analyzed on internal data
- However the banks do use revenue to determine which model should apply (i.e. a large corporate vs. corporate SME, or more granular basis)
- The banks also use a range of profitability metrics as factors in their corporate models

Comments on the proposed risk drivers:

- **Leverage ratio:** Leverage ratio is a strong indicator of risk for large corporates, even when considering all regions and industries, but there are some challenges that will need to be overcome
  - **Availability:** this data will not be consistently available in current systems, especially for smaller counterparties, and sufficient phase in, and a reasonable fall-back, are crucial

- **Revenue**
  - **Availability:** this data will not be consistently available in current systems and to an even greater extent than leverage ratio, especially for smaller counterparties
  - **Predictive power:** revenue has a limited predictive power, even within the global rated corporate universe

Figure 2: Corporates: predictive power by metric



3.3. Alternative proposals

Proposal 3A: continue to use rating where it exists, and where it does not exist use a factor based approach, but without undue conservatism where data is not available.

Where rating exists, it should be used, given the strong predictive power. Leverage is a good candidate for a factor when no rating exists, however we do not agree with the use of revenue as a risk driver. We propose that alternatives be considered, for Dutch banks, and in our analysis, profitability is often used as a factor in models. However revenue is typically used to differentiate between Large Corporates and Corporate SMEs. Note that a prudent, but not unduly conservative, fall-back would be needed in case data was unavailable. Lengthy transition periods would be required.

Proposal 3B: Create a Corporate SME category within the Standardised Approach, and use this opportunity to update the Standardised Approach to include additional types of collateral typically associated with SME lending

The Corporate SME approach will require national calibration, similar to the one proposed for mortgages. For large corporates, given the often international nature of business this may not be necessary, however we propose to investigate whether any sector/geography breakdown would greatly enhance the risk sensitivity (e.g. emerging markets).

Proposal 3C: The approach should be updated to include better recognition of collateral as an additional lever in increasing risk sensitivity and comparability with IRB

The new credit risk SA proposal aims 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 secured by non-financial collateral types that do not qualify as specialized lending.

Proposal 3D: Introduce a slotting approach to improve risk sensitivity for specialised lending

We propose the BCBS investigates whether a simplified “slotting approach” could be used to identify good credit structuring and collateral in order to assign a preferential risk weight.

4. Residential mortgages

This section details the supporting analysis and views relating to the residential mortgages proposal (cf. Section 2.5 of the consultation paper). The section is split into three sub-sections

1. Overarching issues with the current proposal: the first subsection provides our analysis highlighting our perceived issues with the current proposal
2. Assessment of proposed risk drivers: the second assesses the specific risk drivers as proposed
3. Alternative proposals: The third outlines an alternative proposal for the Standardised Approach for the consideration of the BCBS, in order to address those issues identified

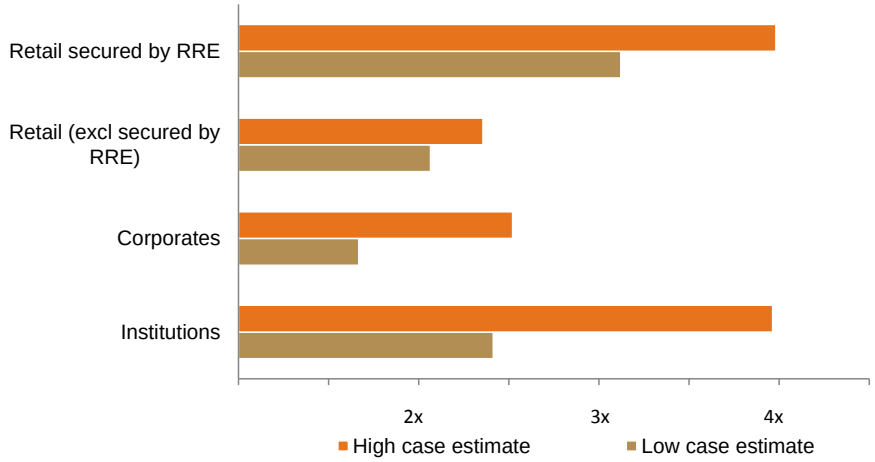
This section address questions 10 – 13 of the consultation.

4.1. Overarching issues with the current proposal

While, in principle, we are not against revisions to the Standardised Approach that increase risk sensitivity within a market, it absolutely crucial that such revisions also yield intuitive results across markets. However, the evidence presented below supports our assertion that this requirement is not met by the current proposal.

Observation 1: The existing proposal would result in a substantial increase in standardised risk weights for Dutch banks. Figure 3 shows the estimated impact on RWAs for Dutch banks, where the multiplier vs. IRB RWA for the proposed risk weights is likely to be a multiple.

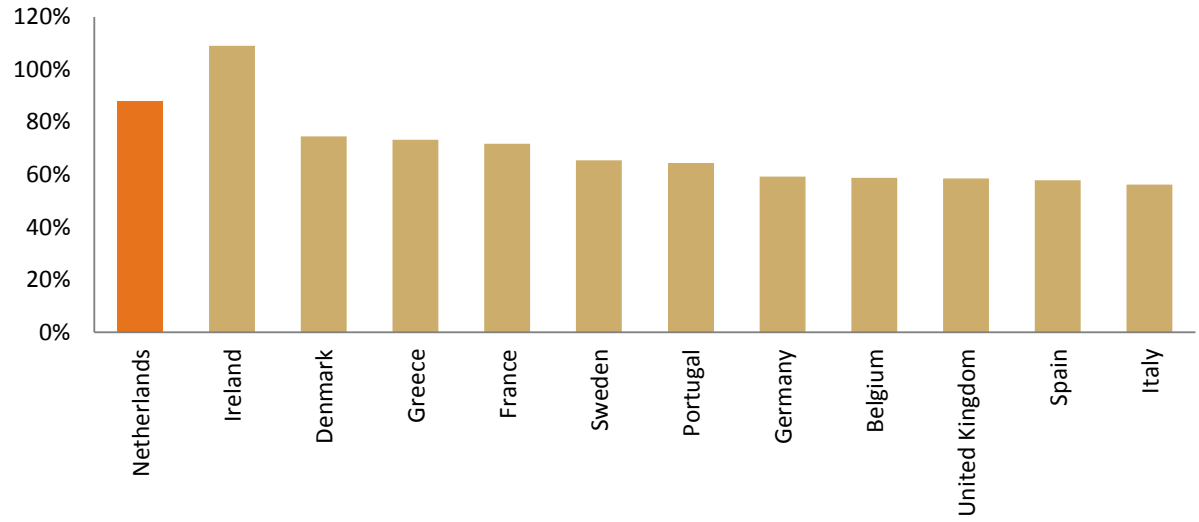
Figure 3: Impact of current proposal on RWAs for Dutch banks vs. IRB RWA



Source: NVB QIS

Observation 2: We also expect that average RW under the proposed methodology would result in a larger increase for Dutch banks over peers given LTVs are on average higher than peer countries, as shown in Figure 4.

Figure 4: Weighted Average LTVs at YE2013

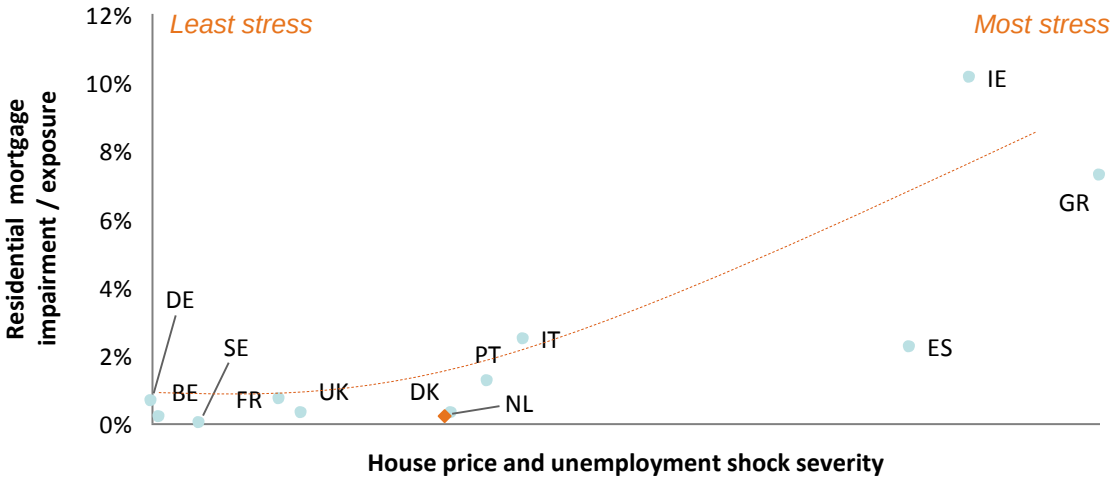


Source: EBA 2014

Observation 3: A proposal which results in a relatively large increase in Risk Weights for Dutch mortgages appears counterintuitive: NL mortgages have shown resilience during the most recent downturn relative to peer markets for a number of structural reasons.

Figure 5 below plots 2013 YE impairments/exposure for mortgages vs. macroeconomic stress - calculated based on peak-to-trough shocks to house prices and unemployment during 2008 - 2014. Whilst the stress in the Netherlands has been relatively severe, the losses have been relatively modest when comparing to the peer group.

Figure 5: Comparison of YE2013 provisions vs. macroeconomic stress



Source: EBA 2014, Oxford Economics

Observation 4: The structural reasons which explain why Dutch mortgages have shown lower risk than other peer markets are significant and widely recognized.

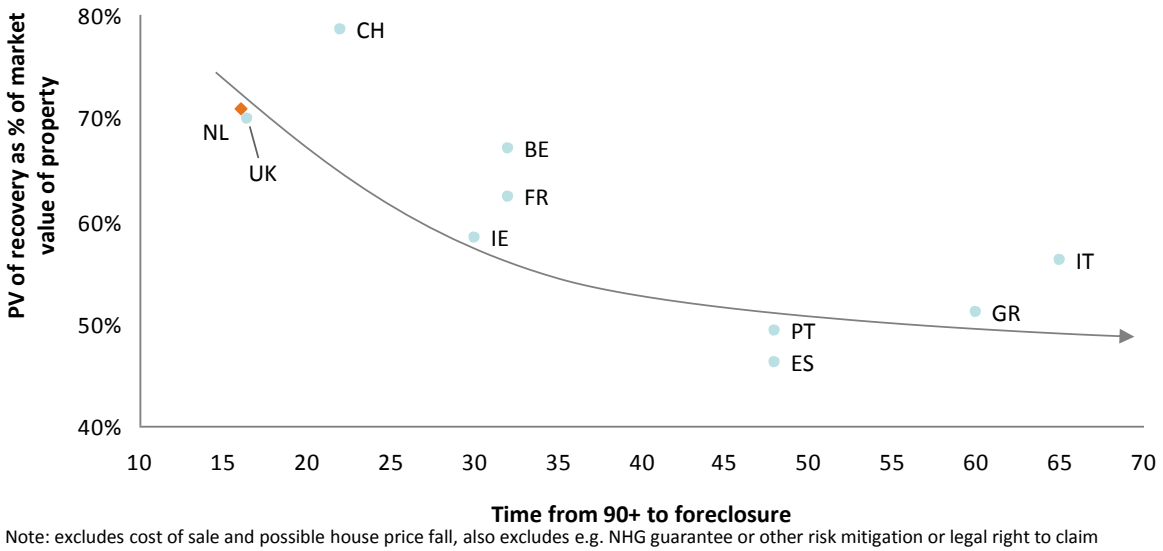
We highlight three key points

1. Legislation allowing short time to foreclosure, and improving recoveries
2. Underwriting and tax legislation that strengthen ability and willingness to pay
3. Sustainable house prices vs. incomes

We present analysis below on each structural reason using publicly available data

1. **Time to foreclosure:** Dutch law allows banks to quickly foreclose properties in recovery – typically between 12 – 18 months, whereas the time to foreclose in other peer markets can be up to 5 years where legislation is driven towards protecting the borrower. This difference alone can halve the present value of recoveries and correspondingly has a large impact on LGDs (see **Fout! Verwijzingsbron niet gevonden.**Figure 6 for further details)

Figure 6: Time to foreclosure vs. PV of recovery



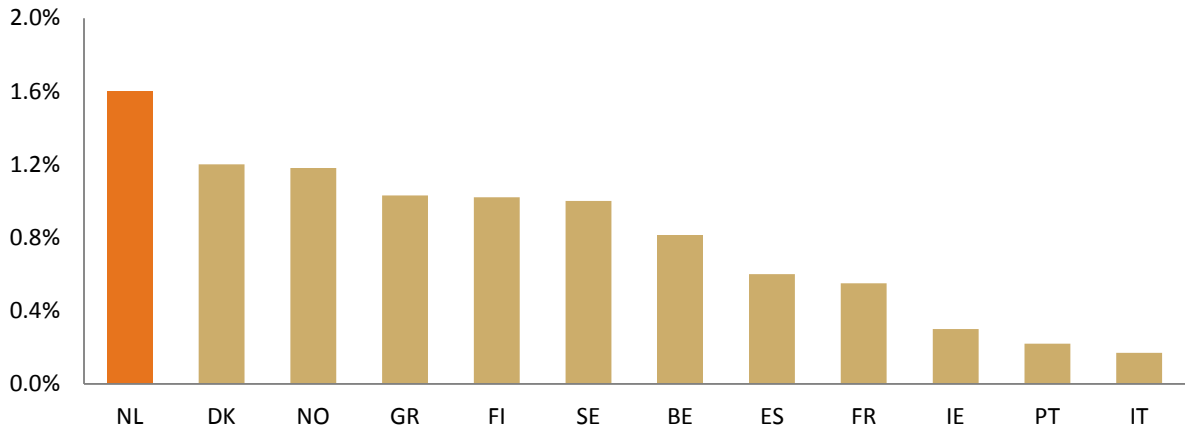
Note: excludes cost of sale and possible house price fall, also excludes e.g. NHG guarantee or other risk mitigation or legal right to claim against future income or other assets of the borrower. NL data reconciled vs. bank's realised timings and haircuts

Source: Fitch RMBS Rating Addendum; Time to foreclosure at the Fitch "BBBsf" stress scenarios, 4% discount rate used

2. **Underwriting and tax incentives:** Dutch law specifies strong underwriting criteria, and also allows for one of the highest tax-benefits in Europe for mortgage owners (see Figure 7). This means that for the same OLTV and debt-income ratio, ability and willingness to pay are higher in the Netherlands than in peer markets. This is corroborated by the methodology used by Fitch Ratings when rating RMBS transactions (see Figure 8). It should also be noted that Dutch RMBS qualify as Level 2b assets within the LCR framework under European Law[4] even if they do not meet LTV requirements due to Dutch National Law which provides a loan-to-income limit on the amount an obligor may borrow.

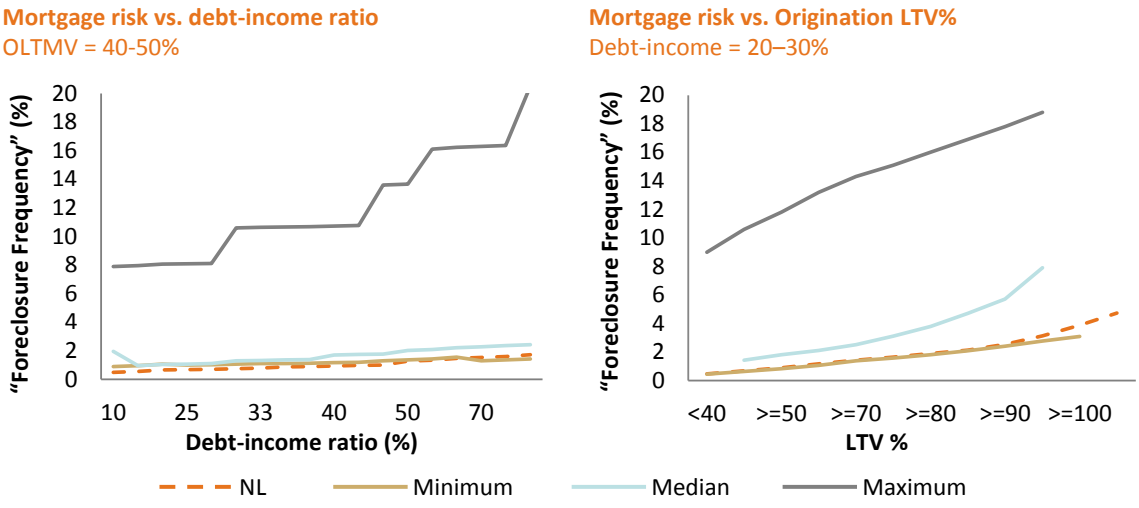
[4] Please refer to LCR regulation, Article 13 (2) (g) (i), and Article 37

Figure 7: Tax benefits on mortgage payments, % (2009)



Source: CBS, OECD, full peer group not available

Figure 8: Comparison of default risk across markets



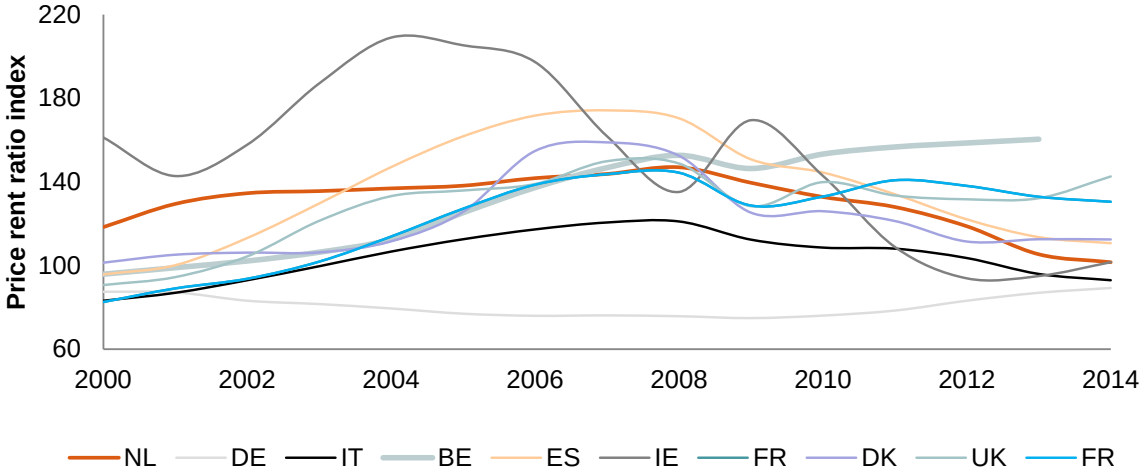
Source: Fitch Ratings
Peer Group: UK, ES, IE, DE, GR, PT, IT, FR, CH, BE

3. **Sustainable house prices vs. incomes:** one of the key indicators of overheating in housing markets is the relationship with income and rental yields. When house prices increase far in excess of incomes the market should be considered much more unstable, and indeed, in the recent crisis many markets saw a correction in this respect (see Figure 9).

4. **Governmental guarantee scheme:** finally, in the Netherlands between 20% and 30% of all residential mortgage loans benefit from a governmental guarantee scheme (Nationale Hypotheek Garantie/NHG). This guarantee scheme lowers the threshold for individuals to

purchase a house, by lowering the risks for banks, and in turn, lower interest rates. As the SA framework will become more risk sensitive, we urge the BCBS to take into account the risk mitigating effects like governmental guarantee schemes or reinsurance, resulting in lower risk weights.

Figure 9: Comparison of house price vs. rents



1. Index based on long term average of price rent ratio
Source: The Economist Statistics

4.2. Assessment of proposed risk drivers

In this section we provide our assessment of the proposed risk drivers in turn (cf. Q10 and Q11). We lay out our proposals to enhance the approach in the next section.

- **Origination LTV (OLTV):** we agree that loan-to-value should be used as one of the differentiators of risk weight (as it is in the current Standardised Approach). We also agree that the numerator should be updated to reflect amortization. However there are some issues we highlight
  - OLTV, especially if used across markets, does not capture differences in time to foreclosure and the corresponding eventual recoveries
  - This metric does not capture the possibility that the origination happens at a peak or trough in the cycle, nor for the fact that house prices rise through the cycle, which impacts both the LGD and the borrower's willingness to pay[5]
  - The risk associated with a given OLTV is not consistent across markets (see Figure 8)
  - Differences in (tax) regulations and redemption incentives can cause incomparability between repayment speeds and curves between markets

[5] Whilst this may lead to more stable, RWAs for residential mortgages across a cycle, it may result in misaligned risk weights and hence alternative mechanismss to generate more valuations should be explored.

  - The metric needs further specification to confirm what types of other collateral (e.g. endowments, pensions, or other linked investments)
  - For origination LTV there would be a need to specify, for example, whether the property value could be updated if a further advance was provided

- **Debt-service-coverage ratio**: while debt-service-coverage ratio is a differentiator of risk (and used by Fitch Ratings in RMBS rating methodology, for example), we highlight several issues
  - DSCR is only a strong predictor of risk close to origination (which makes it more relevant for rating RMBS given seasoning is typically young), and updating this figure by interacting with the borrow on a regular basis would be costly
  - DSCR as a predictor of risk is much weaker in markets where mortgages typically have long initial fixed rate periods (including e.g. the Netherlands)
  - The use of DSCR may reduce the attractiveness of amortising mortgages over interest only mortgages
  - DSCR is not currently well defined, and multiple calculation approaches exist, this is particularly relevant when considering the metric across tax jurisdictions
  - The risk associated with a given DSCR is not consistent across markets (see Figure 8)

4.3. Alternative proposals

This section lays out alternative proposals for the residential mortgage calibration (cf. Q13).

Proposal 2A: Use a local calibration, signed off by a global body

In order to ensure that the relationship between risk weights across markets is intuitive, we propose to use a **local calibration that is signed off by a global body** (e.g. FSB/BCBS in a similar manner to the G-SIFI list of banks). Note that this proposal is **not** comparable to the current concept of "National Discretion". The local calibration should have the following characteristics:

- The calibration should be based on objective national (jurisdiction) level metrics, which are defined and reported for all jurisdictions, ensuring transparency.
- These metrics should be observable and comparable, and should be economic or legislative indicators and bank's input into such metrics should be very limited. For example, whether debt-to-income levels are determined by law for the jurisdiction. Where information is not available conservative fall backs should be applied
- The calibration should be approved at the Global level and reassessed regularly

Proposal 2B: Use Loan-to-Value* and replace DSCR with arrears as the second driver

LTV is a predictor of loss within a given market (*we consider options for the "V" in LTV below) and should continue to be used in the Standardised Framework. However, given the issues highlighted above regarding DSCR as a risk-driver, and in particular the difficulties around calibrating and comparing the relationship between DSCR and risk across local markets using structural and readily

observable metrics, we propose to **remove DSCR as a driver** (cf. Q12). This is in-line with Dutch IRB models, where DSCR is not typically a factor given the low predictive power.

We also expect that most other metrics (e.g. seasoning, % of principle paid down, etc.) which may also be strong indicators of risk would pose similar challenges when implementing a centrally determined local calibration. However, if the BCBS requires one, we consider arrears or non-performing loans to be the better second driver options. This could be used to differentiate between borrowers that have previous arrears/non-performing status vs. those that don't. For example, by creating a flag such as "borrower missed payment during last [12] months?" or "borrower non-performing during last [12] months?" If the answer is "Yes", a higher risk weight would apply. This would be readily available in Dutch, and we expect most other banks', systems. We would therefore welcome discussion and consultation on these two, or other, drivers, with a view to creating the best balance between risk sensitivity whilst minimizing unnecessary volatility.

Proposal 2C: Use a "tranching" approach

We propose to keep the current approach of "tranching" given the alternative would incentivise more opaque lending practices. For example, originating a mortgage just below an LTV threshold with an unsecured loan "add-on" for the remaining value required may reduce the overall risk weight vs. originating a single mortgage at the full LTV.

To make the proposal concrete, we put forward two options below:

Option 1: Market specific look-up table
In its simplest form, this proposal would be similar to the existing Standardised Approach, but where the Inflection Point (IP), which determines when to assign a higher risk weight, is based on a centrally determined local calibration.

***All [numbers] presented below are indicative to demonstrate the approach only, and in no way reflect an actual calibration* which would require additional work.**

LTV	< IP%	>=IP%
No Arrears	[25]%	[100]%
Previous arrears/NPL	Possible higher risk weights	

The inflection point would be determined based on a number of factors, including a forward looking view on risk in the mortgage market, and the legislation in that market – calibrated using empirical evidence as necessary.

- **Mortgage market forward looking risk:** measured based on objective metrics such as average property value/ median income or the level of rental yields) and qualitative considerations (e.g. wage levels relative to productivity)
- **Effectiveness of mortgage market for recoveries** (based on legislation around foreclosure, average time to foreclosure, perfection of collateral etc.)

This approach would be able to capture those differences between local markets highlighted in Section 4.1 by design. Further, consideration of the forward looking mortgage market would also remove the issue that neither OLTV nor current LTV consider whether the valuation is based on a peak or trough in house prices.

Note that the percentages in the table below represent the LTV based Inflection Point (IP), hence these are not risk weights (RWs). The RWs can be calculated by using the table above, where the RW is different depending on whether the LTV is below and above the IP. LTVs above the IP will receive a gradually increasing RW. Also note that the markets with the lowest forward looking risk, and most effective market for recoveries (in the top right of the table below), receive the highest IP, meaning a smaller proportion of mortgages (only those above the IP) would be assigned a higher risk weight in such market.

		Effectiveness of mortgage market for recoveries		
	[IP]	Low	Med	High
Mortgage market forward looking risk	Low	[60]% LTV	[75]% LTV	[90]% LTV
	Medium	[50]% LTV	[65]% LTV	[80]% LTV
	High	[40]% LTV	[55]% LTV	[70]% LTV

An obvious extension to this approach would be to add granularity to the risk weights by introducing multiple LTV buckets (or a continuous version), following a similar approach to the BCBS's proposal, but allowing for centrally determined local calibration. The format for this could be to introduce two inflection points to determine the minimum [25]% and maximum [100]% risk weights, with a fixed number of buckets evenly distributed between the two.

LTV	**< IP_Min**	**…**	**>IP_Max**
No arrears	[25]%	[…]	[100]%
Previous arrears/NPL	Possible higher risk weights		

		Effectiveness of mortgage market for recoveries		
	[IP_MIN]-[IP_MAX]	Low	Med	High
Mortgage market forward looking risk	Low	[60]–[80]%	[75]–[95]%	[90]–[105]%
	Medium	[50]–[75]%	[65]–[90]%	[80]–[100]%
	High	[40]–[70]%	[55]–[85]%	[70]–[95]%

Option 2: Single look-up table with market specific haircut to property value
The second option we propose is to use "Loan-to-Adjusted-Value" as the single driver to determine risk weights.

LT-adjusted-V	<[100]%	[100-110]%	…	
No Arrears	[25]%	[35]%	…	[100]%
Previous Arrears/NPL		Possible higher risk weights		

We propose that the calculation of adjusted value should be based on a simple haircut to the current market value of the property, which is assigned on a national level as part of a centrally determined local calibration.

Such a local calibration to the haircut could be based on a similar set of dimensions to that used under Option 1.

		Effectiveness of mortgage market for recoveries		
	[Haircut]	Low	Med	High
Mortgage market forward looking risk	Low	[25]%	[20]%	[15]%
	Medium	[30]%	[25]%	[20]%
	High	[40]%	[30]%	[25]%

Nederlandse Vereniging van Banken

5. Annex 1 – Response to BCBS questions

This section follows the same structure as Chapter 2 of the BCBS consultation, and addresses each question posed for this consultation.

5.1. Exposures to banks

General comments

- Due to the fact that the BCBS definition for banks is too narrow, too many financial institutions will fall outside the bank classification (for instance in some countries Basel III is not implemented for banks), instead these clients will be treated as Corporates, which makes the accuracy substandard. If the calibration for financials does not require CET1, this will allow a broader definition. **We propose that the BCBS reconsiders whether the scope can be increased.**
- While most of the exposures to banks that the Dutch banks are exposed to consist of better than average credit quality, the first impact analyses showed that the overall risk weights for these exposures show a steep increase for the Dutch banks. **We are aware of the need for a further calibration; nevertheless we wish to state clearly that a significant downward calibration is required to come to reliable risk weights.**
- It seems that covered bonds will be treated identically to other bank exposures. Nevertheless it is quite clear that the risks are considerably lower, due to the preferential claim on the encumbered assets and the implications of the associated legislation. We urge the BCBS to recognise the different risk profiles of covered bonds (compared to other bank exposures) and calibrate the risk weights accordingly.

Questions

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

Please see Section 2.2 for detailed comments and issues relating to the use of CET1, along with an alternative proposal in Section YY. At a high level, our proposal is to continue using external rating given its wide availability and strong relationship with risk. In particular

- Leverage ratio is a non-risk sensitive backstop and has less predictive power than other factors. Basel III CET1 will be available for precisely those banks where there is already a rating

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

Please see Section 2.2 for detailed comments and issues relating to the use of Net NPA. We see this as a stronger metric than CET1, but there are still substantial issues which mean that external rating (excluding sovereign support) is a better alternative.

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

We argue that when dealing with professional counterparties, it is not appropriate to disallow preferential short term risk weights for short term interbank claims which are expected to be rolled over. If a risk assessment would lead to a decision not to roll over it will not be rolled over.

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

Please see Section 2.3 for our proposal for banks. We expect continuing to use external rating would address these concerns for the large majority of bank exposures, leaving only a residual set of counterparties for which a single "unrated" risk weight is the best compromise between simplicity and risk sensitivity. Further, external rating is able to take country risk into consideration.

5.2. Exposures to corporates

General comments

- As formulated above the definition for Banks is too narrow, leading to too many financial counterparties ending up in the corporate bucket.

Questions

Q5. Do respondents have views on the selection of risk drivers and their definition, in particular as regards leverage and the incorporation of off-balance sheet exposures within the ratio? Would other risk drivers better reflect the credit risk of corporate exposures?

Please see Section 3.2 for details of our assessment of the risk drivers. We propose to continue using external rating whenever it is available. However we support the move to increase risk sensitivity for unrated corporates, but urge BCBS to seriously consider implementation issues. Both of the proposed risk drivers will have limited availability, and may not even be reported by a large proportion of counterparties, and the 300% punitive risk charge for unavailable data should be reconsidered to be more aligned to the current "unrated" risk weight approach. The question regarding off-balance sheet exposure seems to be "putting the cart before the horse" in this respect given the most rudimentary leverage ratio already poses significant implementation/data collection challenges. For the specific metrics

- While we agree that revenue should be considered in order to differentiate Corporate SMEs from large corporate, we do not see revenue as a strong risk driver to be used to determine risk weights within these high level segments
- We acknowledge that leverage is a strong risk driver for corporates, but a single driver across all industries and geographies may be too simplistic

Q6. Do respondents have views on the appropriateness of the proposed treatment, especially with regard to SMEs? And about the more lenient treatment for start-up companies?

Please see Section 3.3 for our proposal. We think there are several key enhancements required for the Corporate SME approach

- Inclusion of collateral and other risk mitigating features of the product structure such as classical trade finance structures
- Local calibration depending on market global policy rules
- A calibration that aligns to the IRB approach where correlation assumption is reduced

Q7. Do respondents think that the risk sensitivity of the proposal can be further increased without introducing excessive complexity?

Please see Section 3.3 for our proposal, the key additions relate to better recognition of collateral, and enhanced treatment for Corporate SMEs.

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

Please also see the Trade Finance Annex.

The proposed risk-weights applicable to specialised lending, with a floor at 120% or 150%, is extremely penalizing (at the highest end of the IRB risk weights for the same exposures) and disregards the multiple safeguards (such as structure, collateral and control) and covenants that can be associated with these transactions.

We propose that the slotting approach could be considered and potentially adapted as part of a risk sensitive approach for the SA framework..

There is a strong need for more granularity between the several forms of SL (Project finance, Commodity Finance, etc.). This could be done through:

- Determining specific risk weights by subcategory, taking into account structure/collateral specific elements (for example: if more than 100% commodity collateral)
- Recognition of non-financial collateral through the Credit Risk Mitigation framework (for example: liquid and exchange-tradeable (hence objective valuation) commodities could be recognized in a similar way as gold)
- Define specific lower floors, when structure/collateral is present.

We propose to hold industry surveys/technical meetings with the BIS and AIRB banks in order to find more relevant risk drivers for SL.

5.3. Subordinated debt, equity and other capital instruments

We welcome the idea proposed by the IIF to introduce an add-on to RWA for senior debt to arrive at a plausible risk weight for subordinated debt. The differences between the FIRB senior and subordinated LGD could serve as a good basis for calibration. For equity an additional adjustment on should be considered as well.

5.4. Exposures secured by residential real estate

General comments

- The lion's share of the Dutch residential mortgage exposures is reported on the Internal Rating Based (IRB) approach. The models (PD, LGD and EAD) that are used to calculate the risk weights follow a robust internal process (model building, monitoring, back-testing and validation by independent validation units). We are confident that the current risk weights levels are an adequate reflection of the actual risk profiles. The European ECB Stress Test results (2014) and the European AQR results (2014) confirm this view from the capital markets.
- We are strongly against adding additional levels of conservatism into the risk weights. The risk weights should reflect the actual risk profile. If more conservatism is desired, it should be routed via the capital side (by a higher required CET1% and or buffer). In the recent years the minimum requirements for CET1% were already increased and the agreed phase-in will continue to increase minimum CET1% levels. This made – and will continue to make – the financial system more robust.
- With this knowledge it is striking to learn that the supervisory community that is represented in the BCBS came up with new risk weights (sliced per LTV and DSCR bucket) that result in risk weights increasing substantially (up to two times) for banks reporting these exposures on SA, to even three to five times the current risk weights for banks reporting these exposures on IRB.
- Increasing risk weights out-of-line with actual risks would require banks to either raise more capital (competing for capital with other industries, slowing down economic growth) or banks to adjust their balance sheets (probably both). This would negatively influence the real economy, based on incorrect assumptions. An additional real threat is that these proposals would open the door towards unregulated finance companies, limiting the scope of prudential regulation to a decreasing subset of the wider credit market
- In the Netherlands between 20% and 30% of all residential mortgage loans benefit from a governmental guarantee scheme (Nationale Hypotheek Garantie/NHG). This guarantee scheme lowers the threshold for individuals to purchase a house, by lowering the risks for the banks in the Netherlands, and in turn, lower interest rates. We urge the BCBS to take into account the risk mitigating effects these kinds of guarantees bring, resulting in lower risk weights

Questions

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

We again point to the need for a local calibration. It is also crucial to undergo additional consultation once any proposed risk drivers are identified.

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

Please see Section 4.2 for our assessment of the proposed metrics for retail mortgages. The key point is that both of these metrics can have very different relationships with risk depending on the market/country; for example, a market where legislation allows for quick foreclosure should have a lower risk weight, for a given LTV, than a market where foreclosures take a number of years. And, whilst LTV can be a predictor of risk, DSCR is only relevant (and available) close to origination, and has limited power in markets such as the Netherlands where Dutch law strictly dictates loan-to-income ratios, and the majority of loans have a long initial fixed rate period.

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

Please see Section 4.3 for our alternative proposals. Our proposal includes updating LTV from origination value, and we acknowledge that a set of global polices should be in place to ensure consistent rigour in the measurement of future (desk based) valuations.

Our proposal is to remove the use of DSCR given the significant challenge in updating this metric, and relatively low predictive power when using the metric, beyond the period immediately following origination.

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

We argue this point is even more relevant for LTV which has a very different relationship with risk across jurisdictions, and it is crucial that the framework is updated to address this point. We also agree that there are significant challenges for DSCR which further motivate our proposal to remove it as a metric. For example, the Netherlands currently has strong tax incentives relating to mortgage debt skewing a comparison of DSCR as a predictor of default, relative to jurisdictions without the same incentives.

Q13. Do respondents propose any alternative/additional risk drivers for the Committee's consideration in order to improve the risk sensitivity in this approach without unduly increasing complexity?

Our proposal is detailed in Section 4.3 where we have presented our views in detail on this topic.

We urge the BCBS to develop our proposal for local calibrations, which can be set based on a global set of standards, in particular relating to differentiating risk weights for each LTV bucket depending on the market, including consideration of both

- Forward looking mortgage risk
- The effectiveness of the mortgage market for recoveries

We also propose investigation of arrears as the second driver. For example, it would be possible to use a flag of whether a borrower has been more than 30 days in arrears during the last [12] months as a key predictor of risk.

5.5. Exposures secured by commercial real estate

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

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 more preferable. However, the ranges of risk weights are quite similar whether or not the exposure is considered as unsecured (60% to 130%[6]) 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. 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. 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.

Q15. What other options might prudently increase the risk sensitivity of the commercial real estate treatment without unduly increasing complexity

Similarly to specialised lending, the slotting approach should be considered as a rather risk sensitive approach for the SA framework.

[6] The 300% risk weight is only for cases where the counterparty has negative equity

5.6. Risk weight add-on for exposures with currency mismatch

Q16. Do respondents agree that a risk weight add-on should be applied to only retail exposures and exposures secured by residential real estate? What are other options for addressing this risk in a simple manner?

This is not a material risk in the Netherlands, we have no additional comments on the proposed approach for the purposes of this consultation.

5.7. Off balance-sheet exposures

Q17. Do respondents consider the categories for which a CCF is applied under the standardised approach to be adequately defined? Q18. Do respondents agree that instruments allocated to each of the CCF categories share a similar probability of being drawn and that the probabilities implied by the CCFs are accurate? Please provide empirical support for your response.

Note that this revision will also impact the Leverage ratio, which uses standardised CCFs for off-balance sheet exposures.

Risk weight on commitments that are unconditionally cancellable at any time without prior notice should continue to be treated as 0%, considering the consistency with terms & conditions in the facility agreement.

We disagree with not making a difference between commitments with different maturities (currently with 20% and 50% CCF, depending on the maturity, but now proposed to receive a uniform CCF of 75%) as this approach will not be risk sensitive and does not add to the comparability of RWAs with IRB banks (as the one year maturity floor may be lifted for some trade products). It will also provide wrong incentives for banks to issue commitments for longer periods. It is also not consistent with banks' internal historical drawdown rates.

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 that the existing credit risk SA CCFs of 20% and 50%. We would be keen to understand more the rationale for this, e.g. to see any quantitative analysis justifying the higher CCFs.

Specifically for trade finance, we suggest the BCBS should provide more guidance on the CCFs for guarantees along the lines proposed by the ICC. We are of the opinion a distinction should be made between undrawn lines and other contingent exposures and to address CCFs at product level instead of facility level.

For **trade-related bank exposures**, mostly letters of credit and guarantees, short-term and uncommitted, we suggest to keep the current treatment of favorable CCFs (evidenced by data produced by the ICC[7] for example) and maturity (e.g. lift of one year floor for some products). Indeed, Trade Finance is more a product class than an asset class. Even under the BIS framework this has unfortunately only been partly recognised, despite low historical defaults and losses. Its importance for the global economy as a form of risk diversification, shifting country- and counterparty risk, does not need to be proven anymore. Its resilience has once more been proven during the last crisis as acknowledged in the BIS research paper CGFS No 50 on the subject[8]. There is a risk of a shift towards shadow banking in case the proposals are not adjusted. Finally there is a need for more guidance on definitions, reporting and CCF calibration for both SA and IRB banks (as rightfully advocated by ICC), especially to address the issue of estimating/applying CCFs on product rather than on facility level. This could be done through a technical meeting with IRB banks, ICC and BIS representatives (sharing industry practice and relevant risk drivers).

Note that lending to banks in jurisdictions which have not yet implemented Basel III is often Trade Finance related.

5.8. Past due loans

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

For defaulted assets there might be uncertainty in the provisioning levels (risk of under provisioning), for this uncertainty capital should be allocated. Under the IRB framework the capital for defaulted assets equals the downturn LGD times the exposure minus the provisions. If a prudent level of provisions are allocated, the capital should be very low (communicating vessels). Therefore setting capital levels for defaulted assets without factoring in provisioning levels is a too crude measure. Capital should be equal to the capital as if the asset would be performing minus the provisions.

For retail mortgages, we propose that arrears may be directly included as a factor.

We also request the opportunity to provide further comment once more concrete proposals are formulated.

5.9. Exposures to multilateral development banks

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

We have no comments during this consultation for this question.

[7] ICC = International Chamber of Commerce (www.iccwbo.org)/Global Survey on Trade Finance
[8] BIS research paper: (www.bis.org/publ/cgfs50.pdf)

5.10. Exposures to multilateral development banks

Q21. What exposures would be classified under “Other assets”? Is a 100% risk weight appropriate? (Please provide evidence where possible).

We would like to understand in more detail the proposal for securitisations, and in particular those for which risk weights are determined under the supervisory formula approach – this would have implications for capital floor consultation.

5.11. Credit risk mitigation

Q22. What are respondents’ views on the above alternative ways to define eligible financial collateral?

We agree a very important ingredient in order to arrive at a fair reflection of the actual risk is credit risk mitigation.

The SA framework looks at borrowers’ characteristics, while many banks’ business models are based on a strong structuring (collateral, control, etc.), which is the core skill of banks (credit risk assessment). Not including non-financial risk mitigation is therefore bound to lead to wrong incentives as risk sensitivity would be lost, especially within high-quality portfolios such as mortgages, commodity finance, etc.

We therefore recommend

- Specific risk weights taking into account structure/collateral specific elements (for example: if more than 100% commodity collateral)
- Recognition of non-financial collateral through the Credit Risk Mitigation framework. E.g. In our opinion commodities with deep markets and transparent valuation such as crude oil and wheat should be recognized in a similar way as gold.
- Specific lower floors, when structure/collateral is present.

This would also contribute to a better comparability of RWAs among SA banks and between SA banks and AIRB banks, without the burden for SA banks to develop costly internal models.

Q23. What are respondents’ views on the recalibrated supervisory haircuts shown in Table 4? What are respondents’ views on how to eliminate references to ratings from the supervisory haircuts table? What could be the implications of eliminating references to external ratings? Q24. What are respondents’ views on the proposed corporate guarantor eligibility criteria?

We have no additional comments for these questions for the purposes of this consultation.

6. Annex 2 – Response Focus group Trade & Commodity Finance[9] on the BCBS consultative papers

- **Capital floors: the design of a framework based on standardised approaches**
- **Revisions to the standardised approach (SA) for credit risk.**

(published on December 22, 2014)

Scope

This specific response is the result of a collaboration with the FBF, and is thus submitted both as an annex to general responses from national bank associations - FBF (France) and NVB (The Netherlands) -, and as a focus paper from AFME (European level), and should be read in addition to general responses from banking industry associations (such as IIF, ICC and BAFT). The focus of this paper is exclusively on Trade Finance and Commodity Finance.

Trade Finance is here defined as a product class stretching over several asset classes (SMEs, LCs, FIs, Sovereigns and even Public Sector Entities). Please note that, as a result, Trade Finance has historically never been fully recognised by the BCBS framework, but instead some special capital treatment has been allowed in particular for certain CCFs and for maturities shorter than one year.

Commodity Finance[10] is here defined as focusing on commodities, making use of Trade Finance products, and with a dedicated monitoring/collateral unit.

Introduction

We welcome the stated BCBS objectives to seek convergence and enhanced comparability in RWAs between SA banks and IRB banks and that this be achieved in a simple and risk sensitive manner. However, we would like to express our grave concerns regarding the potential unintended consequences that the current proposals will have on the Trade Finance and Commodity Finance sectors. While some general comments certainly apply to Trade Finance and Commodity Finance, we focus in this response on the asset class Specialised Lending (SL), and on Commodity Finance as a special case. Other comments apply more generally to Trade Finance, for which existing specific capital treatments should be at least kept and moreover some clarification under the BCBS framework is urgently needed. Finally, we also disclose aggregated high-level historical data in the area of Commodity Finance (evidencing its low risk nature) and we propose simple alternatives recognising the specifics of Commodity Finance structures, which are far more risk sensitive than a simple two financial factors-approach and/or a single risk weight/floor for SL. These alternatives therefore more accurately reflect the true risks of Trade and Commodity Finance activities.

Ongoing dialogue after March 27th

Given the consultative nature of the current proposals and their estimated huge impact, an ongoing dialogue, through a technical meeting between the BCBS Task Force and the industry, is deemed necessary to exchange knowledge on risk drivers and IRB modelling practices within the area of SL. This asset class often encompasses low risk businesses which on occasion are incorrectly

[9] The Focus group consists of ABN-Amro, BNP-Paribas, Crédit Agricole-CIB, ING, Natixis, Rabobank and Société Générale.

[10] Please note that whether a bank has historically reported those exposures under Corporates or Corporates-SL was until now not so important, given similar capital treatments, but will become essential given the proposed risk weight for SL.

perceived to carry a higher level of risk because they are somewhat more complex than standard corporate lending. A quantitative industry survey evidencing the low risk nature of Commodity Finance could also be conducted. This would be at a more granular level than the information presented in this response and hence more time would be needed to collect historical data in a consistent manner from the respective banks.

1. General comments

Proposed capital floors are actually to the detriment of low risk businesses

By flattening capital requirements the proposed capital floors actually have the undesirable effect of reducing risk sensitivity and ultimately making the banking sector less resilient. In particular, it demeans the value of structure and reduces the benefit of taking collateral and other forms of security. Furthermore, systemic risk is actually increased because capital outcomes will converge, and the cost of borrowing for Commodity Finance clients significantly raises thus ultimately reducing the availability of liquidity in the international trade finance market. Capital floors, if set at an artificially and unnecessarily high level[11] will thus give wrong incentives to banks that currently have higher quality Commodity Finance portfolios. Floors create the unintended opposite effect for banks to engage in higher margin business (read: higher risk), lending to weaker counterparties for which higher margins can be charged. This, in order to compensate for the higher capital charge required to meet the return on equity targets.

Pursuing and refining industry initiatives for convergence and comparability is thus preferred

We therefore recommend not introducing RSA floors for IRB banks, and instead to pursue and refine existing work aimed at creating more consistency and less variability in RWAs (such as the ongoing work undertaken by IIF on discount rates or downturn LGDs and also work by the ICC on CCFs for trade finance products). Furthermore, we believe it is important to maintain the risk sensitivity of internal risk management tools developed by Commodity Finance banks who have each made substantial investments in AIRB models and which play a crucial role in the banking sector as a whole. For Commodity Finance businesses in particular, we believe that detailed work still needs to be done in this area and would encourage knowledge exchange between the various stakeholders.

2. Specialised Lending

Lack of granularity for SL does not improve risk sensitivity

Specialised Lending includes a broad range of financing types, such as Commodity Finance, Project finance (including Mining and Reserves), Object Finance (such as Shipping and Aircraft), and Commercial Real Estate Finance, all with their specific characteristics and risk profile, hence the design of the AIRB framework distinguishes among these different types. The same granularity in the treatment of SL is certainly needed in the current consultative papers, in order to achieve and to maintain enhanced risk sensitivity. This holds in particular true for Commodity Finance. While we agree that SL might represent only a small part of the portfolio of SA banks, it is often significant for IRB banks, and certainly as a global financing sector across banks. We absolutely do

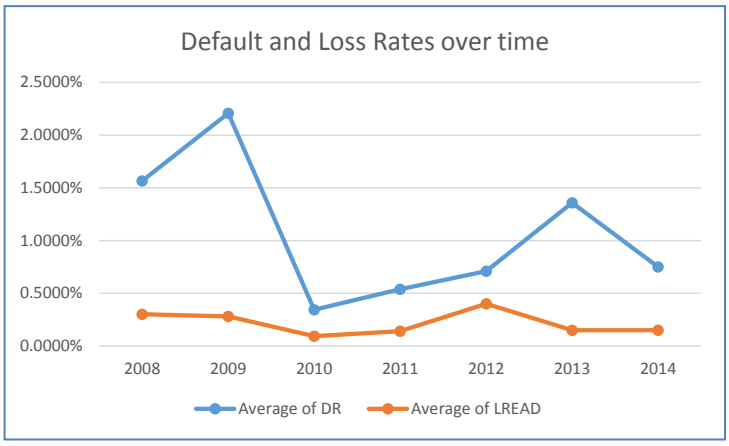
[11] The final calibration of the BIS proposals is still uncertain, but the impact is likely to be significant for IRB banks, if current proposals become reality, while current IRB calibrations are based on own historical data and the process is approved by supervisors. The representativeness of the data used for the calibration, as well as the statistical methods used to determine risk drivers, are therefore questionable at this stage. Using QIS, EBA and other existing historical data is therefore strongly recommended.

not recognise the statement "*Empirical evidence shows that specialised lending generally exhibits higher risk and losses than other types of corporate lending*" and would be keen to learn about the sources of the empirical research leading to this conclusion. For several categories of SL, and certainly Commodity Finance, banks can indeed demonstrate a track record of low losses over time, including a full economic cycle. The historical evidence has in fact already been applied in annual reviews of internal models, where back-testing is an important part of the analysis, and for which regulatory approval has been obtained (although it is recognised that because only a few banks have invested in developing such Trade Finance and Commodity Finance models, industry practice might not be well spread as yet). Additionally, publically available statistics from the EBA also tend to indicate a lower risk profile for SL than for traditional Corporate Lending.

The proposal dismisses the value of structure and collateral in Specialised Lending
The Standardised Approach is borrower specific and does not take into account the structure, collateral and other security types. This extremely narrow approach effectively penalises sound business models such as Commodity Finance (or Project Finance), which are all important for the real economy, even to the point that banks will have to consider carefully whether some of these businesses will remain economically viable under the new proposals. Also, for many banks, low defaults and low losses can be evidenced for those activities, with the bank's proprietary data that are as a rule accessible to the competent supervisor, and in some cases through publications from data pooling initiatives.

3. Commodity Finance

Low risk evidenced by historical data
Anonymously aggregated high-level historical data by six French- and Dutch banks actively involved in Trade and Commodity Finance clearly evidences the low-risk nature of Commodity Finance. These facts clearly reinforce the need for a more risk sensitive calibration for Commodity Finance, which would take into account the specific risk mitigants involved, and their proven historical effectiveness. In particular, observed default rates (ODFs) and loss rates (compared to EAD and exposures) have been collected over the period 2008-2014, see graph below.



The average default rate is estimated at 1.01% while the average loss rate is 0.21% on EAD (and even 0.14% when compared to exposures). Indicative and conservative estimates of implied risk weights, using this average default rate and the highest loss rate observed (2012), are much lower than the currently proposed 120% for Specialised Lending (55% with a maturity of one year, and

69% with a maturity of 2,5 years, while most commodity Finance exposures are even shorter than one year). A technical meeting where the observed loss data and resulting risk weights are discussed in more depth, will in our opinion provide a deeper understanding.

Leverage and revenue not risk sensitive for commodity traders and even lead to capital volatility
Experience with developing internal rating models to establish counterparty ratings for corporates shows that models with sufficient discriminatory power are often based on qualitative as well as quantitative factors. While some leverage ratios (however different from the one currently proposed) and revenues (although not as an absolute figure among all borrowers) may sometimes be considered to be relevant drivers in the quantitative component of certain corporate models, this is certainly not true for counterparties active in commodities. Instead, gross margins, solvency and liquidity factors[12], averaged over a multiyear period, are far more useful indicators. More importantly, leverage and revenues are even considered not risk sensitive for counterparties involved in commodity trade, since there is no risk differentiation through leverage (all are indeed rather similar) and the revenues are volatile as they mostly depend on (variations in) commodity price levels. Moreover, the qualitative component remains extremely important for a forward-looking view, e.g. for commodity traders the quality of management, risk management sophistication, trading practices and hedge methodology have proved to be important factors. Therefore, finding a simple and risk sensitive approach for commodity traders is challenging, but should at least revolve around the above mentioned financial factors instead of those currently proposed (or even a single risk weight/floor of 120%).

Alternatives for Commodity Finance structures
No recognition is given in the current proposals for the short-term, uncommitted and trade-related nature of Trade Finance and Commodity Finance exposures. Trade financings are mostly self-liquidating in nature and truly short-term, i.e. 30 to 90 days. In addition, deals are typically secured by very good quality collateral, such as commodities for which liquid terminal markets exist, or Receivables. We recommend introducing alternatives to the current proposal, and in particular to consider for instance:

- Specific risk weights by subcategory within SL, taking into account structure/collateral specific elements. For example, in case that more than 100% commodity collateral is present;
- Recognition of non-financial collateral through the existing Credit Risk Mitigation framework. For example, liquid and exchange-tradable (hence with an objective valuation) commodities could be recognised in a similar way as gold;
- Define at least specific lower floors, when a strong structure/collateral is present.

4. Trade Finance

ICC ongoing work on Trade Finance
The International Chamber of Commerce (ICC) is considered a leading organisation to promote knowledge exchange between the BCBS Task Force and Trade Finance banks, and to propose alternatives to current proposals for the specific treatment of Trade Finance products. We

[12] Other examples include the current ratio and [Net debt adjusted with RMI/EBITDA], where RMI stands for Readily Marketable Inventories, as defined by the Moody's rating methodology for Commodity Merchandising and Processing companies. Moody's estimates adjustment for RMI to be typically between 20-50% of total inventory depending on the proportion of the company's revenue base and inventory that is tied to their trading operations.

therefore refer to the separate ICC response for more details on Trade Finance, and only highlight some topics in this response. We in particular share the urgent need for clarification of certain Trade Finance definitions such as commitments and unadvised limits, reporting rules on off-balance exposures, and a lower CCF calibration for both SA and IRB banks. Additionally, the issue of estimating/applying CCFs at a product level rather than at a facility level should be addressed explicitly. The current lack of clarity regarding these topics indeed lead to unwelcome variability in RWAs, as banks have used different own assumptions.

Proposed increased CCFs and maturity treatment leads to high impact for Trade Products
In terms of methodology, for trade-related bank exposures, mostly letters of credit and guarantees, short-term and uncommitted, we recommend to keep the current treatment of low CCFs (evidenced by data from ICC in particular) and maturity (e.g. the lifting of the one year floor for some products, and even for all Trade Finance products in some jurisdictions). Unfortunately, Trade Finance is more a product class than an asset class and therefore under the BCBS framework this group of exposures has only been partly recognised, despite obvious low historical defaults and losses. Its importance for the global economy as a form of risk diversification, shifting country- and counterparty risk, does not need to be proven anymore. Its resilience has once more been proven during the last crisis as acknowledged in the BIS research paper CGFS No 50 on the subject. There is moreover a risk of a shift towards shadow banking in case the proposals are not adjusted.