American Bankers Association
Building Success. Together.

Hugh Carney
Vice President of Capital Policy
202-663-5324
hcarney@aba.com

August 23, 2016

Mr. William Coen
Secretary General
Basel Committee on Banking Supervision
Bank for international Settlements
CH-4002 Basel
Switzerland

Re: Proposal to Improve the Risk-Sensitivity of the Standardized Approach to Credit Risk

Dear Mr. Coen:

The American Bankers Association[1] would like to take the opportunity to comment on the Basel Committee's proposals to (1) revise the methodology of the standardized approach to credit risk (the SA Proposal),[2] and (2) impose constraints on risk-weighted asset calculations in the internal ratings based (IRB) approaches to credit risk based on the risk weights of the standardized approach to credit risk (the Constraints Proposal).[3]

As a threshold matter, we note that our primary concern with the SA Proposal continues to be its changes to the credit conversion factor (CCF) framework for off-balance sheet exposures. As many commenters have stated in letters to the Committee, the revised CCFs included in the SA Proposal are calibrated at levels that are inappropriately high and disproportionate to the actual risk of the exposures; could reduce the availability of credit for wholesale and retail customers; and could lead to an overall increase in banks' capital requirements, notwithstanding the Committee's stated intention that the SA Proposal is not designed to increase such requirements.[4]

The Committee's subsequent introduction of the Constraints Proposal has created a new and serious concern for our members: the combined effect of the Constraints Proposal and the standardized approach would significantly reduce the risk-sensitivity of the Committee's overall credit risk framework. In the Constraints Proposal, the Committee seeks to replace the IRB

---

[1] The American Bankers Association is the voice of the nation's $16 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $12 trillion in deposits and extend more than $8 trillion in loans.
[2] *See* Basel Committee on Banking Supervision, Second Consultative Document: Revisions to the Standardized Approach for Credit Risk (Dec. 2015), available at http://www.bis.org/bcbs/publ/d347.htm.
[3] *See* Basel Committee on Banking Supervision, Consultative Document: Reducing Variation in Credit Risk-Weighted Assets – Constraints on the Use of Internal Model Approaches (Mar. 2016), available at http://www.bis.org/bcbs/publ/d362.htm.
[4] We also strongly believe that (1) the 40 percent penalty for credit derivative hedges that do not include "restructuring" as a stated credit event should be removed if the established bankruptcy proceedings would effectively cover restructuring procedures, (2) the revised methodology for repo-style transactions should be applied to margin loans in order to recognize diversification and correlation effects, and (3) the supervisory haircuts for equities collateral should not be increased as proposed.

approaches with the standardized approach for exposures to banks and large corporate obligors, and impose risk weight floors based on the standardized approach for other types of exposures. If the Committee adopted the Constraints Proposal as proposed, the standardized approach would become the binding constraint for the calculation of banks' risk-weighted assets for some of the most significant exposure classes, making the standardized approach much more consequential for banks that use the IRB approaches.

Issues with the Standardized Approach's Risk Weights for Banks and Corporates

The standardized approach is not sufficiently risk-sensitive in its calculation of certain exposure classes to serve as the sole or primary methodology for calculating risk weights, even when considering the changes to the standardized approach contemplated in the SA Proposal. The existing standardized approach references external ratings for rated exposures to banks and corporates and applies a flat risk weight for unrated exposures. In jurisdictions that do not permit the use of external credit ratings, such as the United States, the standardized approach applies a flat risk weight for ***all*** exposures to banks and corporates, regardless of how creditworthy the obligor might be relative to other banks or corporate obligors.

Under the SA Proposal, this framework would be only marginally more risk sensitive. In jurisdictions that permit the use of external credit ratings for regulatory purposes, the SA Proposal would—

- continue to assign risk weights to banks according to a look-up table based on external ratings and whether the exposure is short-term, but would include upward adjustments based on due diligence and would permit the classification of unrated exposures into three different "risk buckets" based on due diligence; and

- continue to assign risk weights to corporates according to a look-up table based on external ratings, but would assign an 85 percent risk weight to small and medium sized entities (SMEs).

In jurisdictions that do not permit the use of external ratings for regulatory purposes, the SA Proposal would—

- assign risk weights to banks according to a look-up table based on three "risk buckets" and whether the exposure is short-term; and

- assign flat risk weights of 75 percent to certain corporates deemed to be "investment grade," 85 percent to SMEs, and 100 percent to other corporate exposures.

Even under the SA Proposal, risk categories would be too few in number and would diverge too widely in terms of risk weights, creating cliff effects. For instance, in jurisdictions that do not permit the use of external ratings, exposures to corporates that are not SMEs would be assigned one of only two categories, even though large corporations present a wide spectrum of actual credit risk. As another example, in jurisdictions that permit the use of external ratings, a single-notch downgrade in a bank's credit rating from AA- to A+ would result in a ***150 percent increase*** in the bank's risk weight (from 20 percent to 50 percent), and a single-notch rating downgrade from BBB- to BB+ would result in a ***100 percent increase*** in risk weight (from 50 percent to 100 percent). With risk weights generally set at 100 percent or greater, the standardized approach – even as revised – is barely more risk-sensitive than the Basel Leverage Ratio with respect to these exposures.

This lack of risk differentiation is compounded by the inaccuracy of the standardized approach, which fails to take into account some of the most important aspects of creditworthiness, including but not limited to seniority, the presence of security (other than financial collateral that qualifies as a credit risk mitigant), and remaining maturity (other than a binary adjustment if the exposure is short-term). Banks using the IRB approaches currently take these factors and others into account in calculating risk weights, but would no longer be permitted to do so if the Committee adopted the Constraints Proposal without improving the standardized approach.

Suggested Improvements to Standardized Approach Risk Weights for Banks and Corporates

In this context, our members have developed a proposal to enhance the risk-sensitivity and accuracy of the standardized approach for exposures to banks and corporates. Under this proposal, which is summarized in the Annex to this letter, a bank would calculate the risk weight of an exposure to a bank or corporate obligor under the standardized approach in three steps:

1. First, the bank would make an internal credit risk assessment to determine a "base" risk weight for the exposure, based on whether the exposure is "Senior Investment Grade," "Investment Grade," "Other Exposures That Are Not In Default," or "High Risk."

2. Second, in recognition of the effect of remaining maturity on risk, the bank would make adjustments based on whether the exposure has a remaining maturity of less than one year, between one year and three years, between three years and five years, or five years or greater.

3. Third, in recognition of the effect of seniority on risk, the bank would introduce a recovery adjustment based on whether the exposure is a senior secured exposure, a senior unsecured exposure, another unsecured exposure, or a subordinated exposure.

In addition, our proposal would apply a total risk weight minimum of 20 percent to every exposure to banks and corporates notwithstanding any lower risk weight that would result based on the three steps above. After calculating the total risk weight based on the three steps above, subject to the 20 percent minimum, the bank would multiply the total risk weight by the amount of its exposure at default (EAD) to generate its risk-weighted assets for the exposure.

As an example, suppose a bank made a 10-year senior secured loan of $10 million to a corporation that the bank determined to be "Investment Grade" based on its due diligence. The "base" risk weight of the exposure would be 50 percent, because the bank determined the corporation to be Investment Grade. The bank would then multiply that base risk weight by a maturity adjustment of 140 percent (because the exposure has a remaining maturity of 5 years or more), for a maturity-adjusted risk weight of 70 percent. The bank would then multiply that maturity-adjusted risk weight by a recovery adjustment of 50 percent (because the loan is a senior secured loan), for a total risk weight of 35 percent. Finally, the bank would multiply the total risk weight of 35 percent by its EAD of $10 million for a total risk-weighted asset amount of $3.5 million.

We believe our proposal would be a significant improvement in the standardized approach in its current form *and* as modified by the SA Proposal. Like the SA Proposal, which incorporates due diligence assessments, our proposal would recognize that banks are well suited to make their own assessments of credit risk by incorporating internal credit risk assessments into the base risk weight calculation. Unlike the SA Proposal, however, our proposal would recognize that an exposure's remaining maturity and seniority are significant drivers of risk by incorporating maturity and recovery adjustments. Importantly, those adjustments for maturity and seniority would be set by regulators under a lookup table, so there is no scope for bank discretion or inconsistency in implementation. Our proposal would also have the virtue of simplicity, because it would include only three steps for risk-weighting, each of which would include distinct categories. In addition, the use of three steps with multiple categories of adjustment would result in highly granular outcomes. Finally, our risk weight minimum of 20 percent would ensure that risk weights would never be lower than the lowest possible risk weight under the current standardized approach and the SA Proposal. In fact, risk weights under our proposal could be much higher than is possible under the current standardized approach and the SA Proposal. All of these benefits would be achieved while minimizing opportunities for unwarranted variability, thereby ensuring improved comparability.

Given that the Constraints Proposal would replace the IRB approaches with the standardized approach for exposures to banks and large corporates, it is critical that the standardized approach become more risk-sensitive in a manner similar to our proposal. We hope to work with the Committee and its members to develop workable and risk-sensitive standards based on our proposal.

If the Committee would like additional information regarding our proposal, please contact me at (202) 663-5324 or hcarney@aba.com.

Sincerely,

Hugh C. Carney
Vice President of Capital Policy

“Enhanced Standardized Approach”

Improve risk sensitivity of standardized RWs while maintaining simplicity

1. The risk sensitivity of standardised approach must be improved
   - Without improvements, there will be significant increases in capital requirements that are both unjustified by the risk, and inconsistent with the G-20 stated target that there should be no such increase.
   - The standardised approaches do not have sufficient granularity or differentiation of credit quality to be a replacement for IRB.
2. Banks should be able to use internal assessments of credit risk to determine base risk weights
   - Banks are good at rank ordering the likelihood of default therefore internal credit risk assessments should be incorporated
   - Dodd-Frank Act prohibits the use of external ratings – putting US banks and corporates at a competitive disadvantage to EU
3. Introduce a Recovery adjustment to recognize lower credit losses from exposures with higher recovery rates
   - In the event of a default the magnitude of credit risk losses depends on the recovery rate
   - There are a number of risk drivers that influence the recovery rate including seniority, security, region and industry. Banks model these drivers in the advanced approaches but there is sufficient data to incorporate a simple recovery adjustment in the standardized approach
4. Introduce a Maturity adjustment to recognize the lower risk of short term credit exposures
   - Without a suitable maturity adjustment, capital will be overstated for short term transactions and understated for long term transactions
5. Apply a risk weight floor of 20%

“Enhanced Standardized Approach”

Determine risk-weights using <u>internal credit risk assessments</u>

	Multiplier	Senior Investment Grade	Investment Grade	Other Exposures that are not in default	High Risk
Base RW	n/a	20%	50%	100%	150%

Recognize the lower credit risk of short term exposures through a <u>Maturity adjustment</u>

		Senior Investment Grade	Investment Grade	Other Exposures that are not in default	High Risk
Exposures < 1 Year	60%	12%	30%	60%	90%
Exposures > 1 Year < 3 years	75%	15%	38%	75%	113%
Exposures > 3 Year < 5 years	100%	20%	50%	100%	150%
Exposure > 5 years	140%	28%	70%	140%	210%

Recognize the lower credit losses from exposures with higher recovery rates through a <u>Recovery adjustment</u>

		Senior Investment Grade	Investment Grade	Other Exposures that are not in default	High Risk
Senior Secured Loans*	50%	10%	25%	50%	75%
Senior Unsecured Exposures	85%	17%	42%	85%	128%
Other Unsecured Exposures	100%	20%	50%	100%	150%
Subordinated Exposures	150%	30%	75%	150%	225%

<u>Step 1:</u>
Calculate base risk weight

<u>Step 2:</u>
Apply the maturity multiplier
[50% RW * 140% for 10y exposure = 70%]

<u>Step 3:</u>
Apply the Recovery Adjustment
[70% * 50% for senior secured = 35%]

<u>Step 4:</u>
Apply Risk Weight to EAD to determine RWAs

* And other senior secured exposures ranking pari-passu