

March 11, 2016

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

Re: Comments in Response to Consultative Document – Revisions to the Standardised Approach for Credit Risk.

Ladies and Gentlemen:

The Clearing House Association L.L.C. (“**The Clearing House**”), the Securities Industry & Financial Markets Association and the Financial Services Roundtable (collectively, the “**Associations**”)¹ appreciate the opportunity to comment on the Basel Committee on Banking Supervision’s (the “**Basel Committee**”) second consultative document regarding “*Revisions to the Standardised Approach for Credit Risk*” (the “**Second Consultation**”).²

The Associations very much appreciate the Basel Committee’s efforts to address the issues raised by commenters with respect to the first consultative document published in December 2014 (the “**First Consultation**”) on proposed revisions to the standardized approach for credit risk (the “**Standardized Approach**”),³ as well as the Basel Committee’s stated goals of balancing simplicity and risk sensitivity, promoting comparability by reducing variability in risk-weighted assets across banking organizations and jurisdictions, and ensuring that the Standardized Approach constitutes a suitable alternative and complement to the internal ratings-based approach (the “**Advanced Approach**”). We are also appreciative of, and would like to extend our gratitude for, the meetings hosted by the Task Force on Standardized Approaches in Frankfurt on February 24, 2015 and in Basel on February 17, 2016 to discuss the First and Second Consultations respectively.

The Associations continue to strongly support the maintenance by banking organizations of robust and risk-appropriate capital levels and support the Basel Committee’s

¹ Descriptions of the Associations are provided in Annex A of this letter.

² Basel Committee, Second Consultative Document: Revisions to the Standardised Approach for Credit Risk (Credit Risk Proposal) (December 2015) (the “**Second Consultation**”), available at: <http://www.bis.org/bcbs/publ/d347.pdf>.

³ See Basel Committee, Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version (Basel II) (June 2006) (“**Basel II**”), available at: <http://www.bis.org/publ/bcbs128.htm> and Basel Committee, Consultative Document: Revisions to the Standardised Approach for Credit Risk (Credit Risk Proposal) (December 2014), available at: <http://www.bis.org/bcbs/publ/d307.pdf>.

efforts to improve the Standardized Approach. We believe that a number of the Basel Committee's proposed revisions in the Second Consultation are appropriate. In particular, we support the Basel Committee's adoption of a standard for corporate exposures that properly distinguishes corporate entities based on whether they are "investment grade," the elimination of the proposed usage of certain ratios for a number of exposure classes, the adoption of a loan-to-value ("**LTV**") ratio for real estate exposures that considers the LTV at origination, rather than the current LTV, and the introduction of increased risk sensitivity to the credit risk mitigation framework, notably the treatment of securities financing transactions ("**SFTs**").

Nevertheless, we believe that there are several areas in which the Second Consultation, as well as the Basel Committee's process for further reforming the international Basel capital framework, should be appropriately modified to better support the Basel Committee's stated objectives. Part I of this letter provides an executive summary of our comments; Part II discusses the importance of providing subject banking organizations with the opportunity to evaluate holistically the entire package of revisions to the Basel capital framework; and Part III of this letter sets forth our comments on the specific revisions to the Standardized Approach proposed in the Second Consultation.

I. Executive Summary

- The Basel Committee is in the process of undertaking a number of significant revisions to the Standardized Approach framework that it seemingly intends to finalize in a series of distinct and separate steps. When implemented, these changes will result in a near wholesale revision of the calculation of risk-weighted assets and will represent the most substantial revisions to this calculation since the implementation of the Basel II accords. The piecemeal approach to implementing revisions to the capital framework does not provide banking organizations and other interested parties with an opportunity to holistically review and comment on the entirety of the Basel Committee's revisions.
- We are concerned that our ability to comment meaningfully on the Second Consultation is substantially hindered by the absence of a fulsome quantitative analysis and the lack of disclosure of the underlying data the Basel Committee relied upon to preliminarily set certain of the risk-weightings and the credit conversion factors ("**CCFs**") for off-balance sheet commitments. The quantitative impact study ("**QIS**") submission with respect to the Second Consultation is due in early April⁴—after the expiration of the comment period for the Second Consultation—and therefore the Associations and other interested parties will not be able to meaningfully leverage the QIS results for purposes of commenting on the Second Consultation.

In the absence of the completion of the QIS and public release of the related data, our initial comments and recommendations regarding the Second Consultation include:

⁴ Basel Committee, Instructions for Basel III Monitoring at page 188 (January 2016), available at: https://www.bis.org/bcbis/qis/biiiimplmoninstr_jan16.pdf.

- For each of the external credit rating and non-external credit rating approaches for risk-weighting exposures to banking organizations and corporates, the risk-weights applicable for the external credit rating-based approaches are significantly more risk-sensitive and in each case provide options for lower risk weights for highly rated entities, presenting a material inequity and a disharmonization in the effective capital requirements across jurisdictions that should be remedied, including through appropriate national discretion for jurisdictions that do not allow the use of external credit ratings.
- The requirements in the investment grade standard for exposures to corporates that the entity must have public securities outstanding, which must not be positively correlated with the credit risk of the exposures for which they provide guarantees, are both unnecessary and counterproductive. We believe that the policy concerns underlying the requirements are better addressed through holistic standards for investment grade determinations that are subject to appropriate supervisory oversight.
- The Second Consultation's revised CCFs will necessarily lead to increased risk-based capital requirements for certain off-balance sheet commitments. Although the Basel Committee states that it has reviewed QIS and other data as part of its indicative calibrations, the indicative CCFs do not appear justified based on banking organizations' experience with many of the types of commitments included in the revised factors. Moreover, it is far from clear that the cumulative effect of these unquestionable increases in risk-weighted assets will not, in fact, lead to an overall increase in capital requirements under the Second Consultation, in direct conflict with the Basel Committee's statement that the Second Consultation is not designed to increase overall capital requirements.
- Most troubling is the undeniable fact that if these same CCFs are ultimately incorporated into the current Basel III internationally agreed upon leverage ratio denominator exposure measure, leverage ratio capital requirements would necessarily increase. We are deeply concerned that this increase would be unjustified and would make the already blunt leverage ratio instrument more of a binding constraint and further depart, as a practical matter, from the Basel Committee's stated policy of the leverage ratio acting as a back-stop measure to risk-weighted asset calculations. This would be even more problematic in jurisdictions that have adopted a supplementary leverage ratio requirement higher than the Basel Committee's three percent calibration.
- The credit risk mitigation framework's haircuts for equity and corporate debt securities remain too high relative to their overall risk profile and may unduly penalize institutions that accept such collateral. These relatively high haircuts are particularly inappropriate in light of existing data on market haircuts, as well as the capital and liquidity regulations that affect SFTs, including the net stable funding ratio ("**NSFR**"), the liquidity coverage ratio ("**LCR**"), the capital surcharge for global systemically important banks ("**GSIB surcharge**"), and the Basel III leverage ratio.
- The Second Consultation's current approach to the proposed exclusion of smaller issuances from the SFT netting set for purposes of the credit risk mitigation framework could lead to an unwarranted distortion of data. To mitigate this limitation, rather than

excluding the smallest issuances based on their size relative to the largest issuances, we recommend that the Basel Committee compare the smallest issuances to the average size of all issuances within the netting set.

- Given that banking organizations already consider material foreign exchange exposures as part of a borrower's credit risk, a separate and specific add-on for all foreign exchange exposures under the Standardized Approach is not warranted, particularly in light of the difficulties of applying the proposed standard in practice with respect to many potential wholesale borrowers.
- Finally, we believe that the Basel Committee should provide for national discretion in respect of lower risk-weights for: (i) banking organizations that have non-significant equity exposures that are not subject to an equity capital deduction; (ii) equity exposures made under "legislated programmes" such as, in the United States, legislation designed to promote investment in the equity of community development or other organizations; or (iii) certain equity exposures that are part of a hedged pair of equity exposures that form an effective hedge.

II. The Basel Committee has undertaken substantial revisions to the Basel capital framework and should provide the opportunity for comments on a holistic basis, including with respect to QIS results and calibration.

A. Basel Framework Revisions Process

At the outset, we note that the Basel Committee has undertaken, or at the very least announced,⁵ a number of potentially substantial revisions to the Standardized Approach framework, including: (i) the Second Consultation; (ii) the calibration of new risk-weights for exposure classes under the Standardized Approach for credit risk based on QIS results;⁶ (iii) the calibration of revised CCFs; and (iv) the introduction of a choice of three potential capital floors methodologies to the internal ratings-based approach, including one based on the Standardized Approach as a whole.⁷ If implemented along with the other proposed revisions to the Basel III framework, these changes would result in a near wholesale revision of the calculation of risk-weighted assets and the most substantial revisions to this calculation since the implementation of the Basel II accords.

Unlike the implementation of Basel II, however, the Basel Committee has undertaken these revisions in a series of distinct and separate steps rather than as a

⁵ See Basel Committee on Banking Supervision, Finalising post-crisis reforms: an update – A report to G20 Leaders (Nov. 13, 2015); see also Speech by Stefan Ingves, Chairman of the Basel Committee and Governor of Sveriges Riksbank, 2015 Annual Convention of the Asociación de Mercados Financieros (Nov. 2, 2015).

⁶ Second Consultation, at 23.

⁷ See Speech by Stefan Ingves, Chairman of the Basel Committee and Governor of Sveriges Riksbank, 2015 Annual Convention of the Asociación de Mercados Financieros (Nov. 2, 2015); see also Basel Committee, Capital Floors: the Design of a Framework Based on Standardised Approaches - Consultative Document (December 2014), available at: <http://www.bis.org/bcbs/publ/d306.htm>.

comprehensive review of the calculation of risk-weighted assets. Although the Basel Committee has sought, or presumably will seek, comment on most of these proposed revisions, this piecemeal approach to implementing revisions to the capital framework does not provide banking organizations and other interested parties with an opportunity to holistically review and comment on the entirety of the Basel Committee's revisions in the same manner afforded during the Basel II process. Rather, banking organizations and interested parties are in the unenviable position of having to comment on each particular proposal piecemeal without the benefit of considering the potential cumulative and/or synergistic effects of each of the Basel Committee's proposals taken together. As a result, to the extent a particular proposal or element of a proposal has previously been finalized by the Basel Committee, an interested party's comments on a future proposal that is substantially influenced by the already finalized proposal are limited to comments on the proposal then at hand, even where the most substantive effects of these reforms as a whole may—in hindsight—relate to the previously finalized proposal.

Furthermore, we note that while the Second Consultation reiterates that increasing overall capital requirements is not a stated objective of the Basel Committee,⁸ the totality of recent Basel Committee proposals will in fact increase capital requirements as a practical matter. The Basel Committee has, for example, already acknowledged that a 40 percent increase in trading book capital requirements is expected as a result of its fundamental review of the trading book exercise and that capital requirements for securitizations will increase under the revisions finalized in December 2014.⁹ Based on the preliminary risk-weightings and CCFs set forth in the Second Consultation, we are concerned that the same will be the case under the current proposal, even when taking into account the greater degree of granularity of certain categories of risk-weighted assets.

In light of the foregoing, we respectfully request that, prior to the finalization of the Basel Committee's reform package, including the Second Consultation and its related calibrations, interested parties should be provided with the opportunity to comment on the entirety of the Basel Committee's proposed revisions and calibrations to enable a holistic review of the cumulative effect of the proposed revisions. The opportunity to comment on the entirety of the Basel Committee's proposed reforms will assist in evaluating whether the proposed reforms are consistent with one another and with other rules, provide the Basel Committee with comments on the overall effect of the reforms, and, we believe, ultimately result in more informed revisions and appropriate calibrations.

B. Finalization of Second Consultation and the QIS Results

In the Second Consultation, the Basel Committee announced plans to conduct a second QIS as part of the Basel III monitoring exercise based on year-end 2015 data that will inform the calibrations of any proposed revisions to the Standardized Approach and for the finalization of the credit risk proposal, both of which the Basel Committee has endeavored to

⁸ Second Consultation, at 3.

⁹ Basel Committee, Explanatory Note on the Revised Minimum Capital Requirements for Market Risk (Jan. 2016), available at http://www.bis.org/bcbs/publ/d352_note.pdf.

finalize by the end of this year.¹⁰ This QIS submission is due early April 2016, shortly after the expiration of the comment period for the Second Consultation.¹¹ This timeline does not afford the Associations and industry participants the ability to leverage the QIS results for purposes of commenting on the Second Consultation. As it relates to several proposals in the Second Consultation, such as the proposed revisions to the CCFs, we believe that the inability to meaningfully utilize the QIS results significantly constrains the Associations' ability to effectively evaluate the relevant aspects of the Basel Committee's revised proposals and provide fully informed comments. This issue is even more important given the fact that the Basel Committee has not yet announced whether it will provide an opportunity for public comment on any proposed calibrations that result from the QIS.

As such, we believe it is crucial that the Basel Committee either reopen the comment period for the Second Consultation after the completion of the QIS or confirm that interested parties will have the opportunity to provide additional comments based upon this QIS results to better inform any comments made on the Second Consultation and to inform any proposed calibrations in the future. Providing a supplemental opportunity to comment after the provision of the QIS results will enable interested parties, including the Associations, to leverage these results and better comment on the effect of the proposed revisions, while allowing the Basel Committee to review comments on the overall proposed framework in the interim.

III. Comments Regarding the Second Consultation

A. The Associations Support Several of the Proposed Revisions contained in the Second Consultation

The Associations support a number of the Basel Committee's proposed changes in the Second Consultation. For example, consistent with the comments expressed by The Clearing House in its comment letter on the First Consultation,¹² we support the Basel Committee's: (i) adoption of a standard for corporate exposures that properly distinguishes corporate entities based on whether they are "investment grade;" (ii) elimination of the proposed usage of certain ratios for a number of exposure classes (*i.e.*, the reliance on leverage for corporate exposures, a "non-performing assets" ratio for banking organizations, and a debt-service coverage ratio for real estate exposures); (iii) adoption of a LTV ratio for real estate exposures that considers the LTV at origination, rather than the current LTV; and (iv) introduction of increased risk sensitivity to the credit risk mitigation framework. In particular, with respect to the credit risk mitigation framework, the Associations strongly support the

¹⁰ Group of Central Bank Governors and Heads of Supervision, Basel Committee, Revised Market Risk Framework and Work Programme for Basel Committee is Endorsed by its Governing Body (January 11, 2016), available at: <http://www.bis.org/press/p160111.htm>.

¹¹ Basel Committee, Instructions for Basel III Monitoring at page 188 (January 2016), available at: https://www.bis.org/bcbs/qis/biiiimplmoninstr_jan16.pdf.

¹² The Clearing House Association, Comments in Response to Consultative Documents – Revisions to the Standardised Approach for Credit Risk and Capital Floors: The Design of a Framework Based on Standardised Approaches (March 26, 2015) (the "**TCH Comment Letter**"), available at: <https://www.theclearinghouse.org/~media/files/association%20related%20documents/20150326%20letter%20to%20basel%20on%20standardized%20approach.pdf>.

Second Consultation's introduction of a revised methodology for the measurement of exposures to SFTs, which addresses material flaws in the existing haircut-based comprehensive approach and therefore results in a far more accurate assessment of underlying risk. This revised methodology includes changes that permit the netting of loans and offsetting collateral, the use of a factor to approximate correlation on a market-wide basis, and the use of a factor to approximate the impact of portfolio diversification.

In addition, we support the Basel Committee's confirmation that national supervisory authorities have the discretion to deviate from the global minimum standards when it is not possible, due to national characteristics, to apply the global minimum in the same manner, so long as any resulting treatment results in a more conservative standard.¹³ As noted in the TCH Comment Letter, there is concern that any wholesale elimination of the ability of national supervisors to deviate from the global standard in light of specific characteristics of the applicable national regulatory regime, such as binding legislation, will unduly and negatively affect certain jurisdictions with no commensurate benefit.¹⁴

B. Specific Comments on the Second Consultation

In light of the Associations' support of a number of changes proposed by the Basel Committee, the comments below on certain aspects of the Second Consultation are intended to further the Basel Committee's stated goals of updating the Standardized Approach to balance simplicity and risk sensitivity and to promote comparability in risk-weighted assets across banking organizations and jurisdictions in a manner that is not designed to increase overall capital requirements on banking organizations.

1. Risk-weighting Under External Credit Rating and Non-External Credit Rating Approaches

The Associations support the decision by the Basel Committee to provide for an alternative risk-weighting approach for exposures to banking organizations and corporates that does not rely on external credit ratings. However, we note that for each of the external credit ratings and non-external credit ratings approaches for risk-weighting exposures to banking organizations and corporates, the risk-weighting tables for the external credit ratings approach is significantly more risk-sensitive and in each case provides options for lower risk-weights for highly rated entities (for example, the external credit ratings approach provides a 20 percent risk-weight for AAA to AA- borrowers whereas the lowest risk-weight under the non-external credit ratings approach is 50 percent). Any disparity in the risk-weightings between the two approaches will result in the disharmonization of the calculations of exposures to the very same entity between banking organizations subject to supervision in different jurisdictions, a result that is contrary to the Basel Committee's goal of promoting comparability of risk-weighting across jurisdictions. More specifically, if a U.S. and a European banking organization are each analyzing the capital effect of a product for a high quality borrower, the U.S. banking organization would be required to hold over two times more capital for the same product for such borrower than its European counterpart, presenting a material competitive inequity in the

¹³ Second Consultation, at 2.

¹⁴ TCH Comment Letter, at 21-22.

capital requirements and a disharmonization in the effective capital requirements across jurisdictions. This could also distort the provision of services and the pricing for such services to the same customer between such banking organizations and introduce unwarranted competitive disadvantages for jurisdictions that do not allow the use of the external credit ratings approach.

In addition, these relatively less risk-sensitive non-external credit ratings approaches are likely to principally apply in particular to the largest banking organizations in the United States, the only major jurisdiction where there is a statutory prohibition on the incorporation of credit ratings in Federal regulations that require an assessment of creditworthiness,¹⁵ and where the U.S. Federal banking agencies have stated that the Basel Committee's revised Standardized Approach "would apply primarily to large, internationally active banking organizations and not to community banking organizations."¹⁶ Although it is possible that the disharmonization of the calculations of exposures between the external credit ratings and non-external credit ratings approaches may (or may not) be mitigated or accounted for by the aggregate effects of the framework calibrations ultimately adopted by the Basel Committee, the Second Consultation, on its face, does not account for this potentially divergent treatment of the same exposures by different jurisdictions based solely on choices made by the Basel Committee. As a matter of fundamental fairness, we believe that any internationally agreed standardized framework must treat exposures having the same risk characteristics with the same risk-weight, irrespective of the use of credit ratings. We do not believe there is a rational justification for the same exposure being subject to a different risk-weight under an internationally agreed framework based solely on where the banking organization doing the calculation is based.

To address these concerns, the Associations recommend that the Basel Committee either provide for appropriate national discretion under the final framework to allow regulators in jurisdictions subject to the non-external credit ratings approach to make appropriate adjustments to avoid such disharmonization, or provide for comparable risk-weightings under each of the external credit ratings and non-external credit ratings approaches in order to provide a level playing field for all banking organizations. One possible approach would be to introduce the OECD Country Risk Classifications ("**CRC**")¹⁷ as a secondary risk categorization element of the Standardized Credit Risk Assessment Approach ("**SCRA**") to risk-weighting bank exposures, whereby the CRC rating of a bank's home jurisdiction could be used to reduce the applicable risk-weighting for a banking organization that would otherwise fall

¹⁵ Section 939A of the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act required every Federal agency to review existing regulations that require the use of an assessment of the creditworthiness and any references to credit ratings in such regulations; to modify such regulations identified in the review to remove any reference to, or requirement of reliance on credit ratings; and substitute with a standard of creditworthiness as the agency shall determine as appropriate for such regulations.

¹⁶ Banking Agencies' Statement Regarding the Basel Committee's Second Consultative Paper, "Revisions to the Standardized Approach for Credit Risk" (Dec. 10, 2015), available at: <http://www.federalreserve.gov/newsevents/press/bcreg/20151210b.htm>.

¹⁷ See Organisation for Economic Cooperation and Development, Country Risk Classification (Oct. 30, 2015), available at: <http://www.oecd.org/tad/xcred/crc.htm>.

under Grade A under the SCRA to 20 percent to align more closely to the external credit ratings approach. We believe this approach would be consistent with the Second Consultation's statement that "where external credit ratings are not available or used . . . incorporating [CRC] ratings as an objective criterion for each grade bucket" may serve as a useful backstop for introducing finer gradations into the SCRA approach.¹⁸ Of course, there may be other solutions to this issue and we are ready to work with the Basel Committee to find an acceptable solution that eliminates this unfair disparity while preserving appropriate risk-based sensitivity in a rational way.

2. Investment Grade

In defining whether an exposure is "investment grade," the Second Consultation provides that for exposures to corporates to qualify as investment grade, the entity must have public securities outstanding, which must not be positively correlated with the credit risk of the exposures for which they provide guarantees. We believe that making these two elements mandatory requirements of the framework is unnecessary and counterproductive. Indeed, we believe that these issues are better addressed through holistic standards for investment grade determinations that are subject to appropriately rigorous supervisory oversight.

With respect to the public securities requirement, we note that many creditworthy organizations—including pension funds, mutual funds, and sovereign wealth funds—will not have publicly issued securities but are internally assessed by banking organizations, with the oversight of their supervisors, to be investment grade. Regarding the correlation condition, because a banking organization's exposure to a borrower and guarantor is generally underwritten as a single "long" position in a given credit exposure, the correlation between a borrower and its guarantor is already taken into consideration in the decision to extend credit.

The Second Consultation's incorporation of each of these standards appears designed to ensure that any investment grade determination by a banking organization necessarily incorporates meaningful financial analytics to determine the creditworthiness of a given counterparty. In this respect, we believe a banking organization's internal "investment grade" determination, subject to appropriately strong supervisory standards and review that are designed to ensure that banking organizations have meaningful analytical data, is more appropriate than this somewhat artificial distinction in the Second Consultation. We believe the U.S. experience is instructive in this regard as the U.S. Federal banking agencies have implemented rules requiring that banking organizations consider a set of comprehensive factors before they can consider corporate counterparties as investment grade. These factors are periodically revised and updated to reflect market experience, and more detailed guidance is provided for exposure classes that present more complex evaluation questions, such as structured securities.¹⁹ The U.S. Federal banking agencies' current factors are set forth in **Annex**

¹⁸ Second Consultation, at 6.

¹⁹ See Office of the Comptroller of the Currency, Guidance on Due Diligence Requirements in Determining Whether Securities Are Eligible for Investment, pg. 4, available at: <http://www.federalreserve.gov/bankinforeg/srletters/sr1215a1.pdf>; Federal Deposit Insurance Corporation, Guidance on Due Diligence Requirements for Savings Associations in Determining

B of this letter. We believe that eliminating the public securities outstanding and correlation conditions for investment grade status outlined in the Second Consultation²⁰ and replacing them with a more generally applicable, multi-factor approach similar to that set forth in **Annex B**, with appropriate oversight of implementation of this approach to investment grade determinations by national supervisors, would facilitate a more comprehensive and appropriate evaluation of counterparty credit risk.

3. Off-Balance Sheet Credit Conversion Factors

The Second Consultation states that, based on reviews carried out by the Basel Committee in 2014 and data received under the internal-ratings based approach, the current range of CCFs for off-balance sheet commitments is inappropriate and should be recalibrated higher. The Basel Committee further indicates that it expects to finalize the proposed CCFs based on its review of forthcoming QIS results, but has included indicative CCFs for retail and corporate exposures that, in both cases, are higher than the current CCFs in the Standardized Approach.

As an initial matter, we note that the Basel Committee's proposed CCFs will necessarily lead to increased risk-based capital requirements for the affected exposures. Indeed, the upward revision of CCFs is likely to be the largest factor contributing to an increase in risk-weighted assets that banking organizations have preliminarily expected to result from the revisions proposed under the Second Consultation. Although the revised CCFs for corporate exposures are accompanied by revised risk weights in other areas, it is far from clear that the cumulative effect of these unquestionable increases in risk-weighted assets will not, in fact, lead to an overall increase in capital requirements under the Second Consultation, in direct conflict with the Basel Committee's statement that the Second Consultation is not designed to increase overall capital requirements.²¹ Moreover, the Basel Committee did not propose any corresponding change to the 75 percent risk weight for retail exposures, and thus any increase in the applicable CCFs for these exposures will result in a significant increase in risk-weighted assets.

In any event, without the benefit of the review of the data relied upon by the Basel Committee, including the forthcoming QIS results, meaningfully commenting on the cumulative effect of the Second Consultation or any proposed calibrations of the CCF and the associated risk weights is difficult. As discussed in the TCH Comment Letter,²² the Associations

Whether a Corporate Debt Security Is Eligible for Investment, 77 Fed. Reg. 43,155 (July 24, 2012), available at: https://www.fdic.gov/regulations/laws/federal/2012/2012-07-24_final-guidance.pdf; Board of Governors of the Federal Reserve System, Supervision & Regulation Letter 12-5: Investing in Securities without Reliance on Nationally Recognized Statistical Rating Organization Ratings (November 15, 2012), available at: <http://www.federalreserve.gov/bankinforeg/srletters/sr1215.pdf>.

²⁰ Second Consultation, ¶ 173, at 60.

²¹ Id. at 3; FSB, Letter to G20 Finance Ministers and Central Bank Governors (Feb. 22, 2016), at 5 (“While the Basel Committee will address during 2016 elements of the Basel III framework to ensure its coherence and maximize its effectiveness, in doing so authorities are focused on not significantly increasing overall capital requirements across the banking sector.”).

²² TCH Comment Letter, at 12-15.

strongly urge that any results supporting the proposed calibration of the CCFs be publicly released so that the industry has an opportunity to review the Basel Committee's findings. In addition, as noted above, we believe that the ability to aggregate and analyze the data for the upcoming QIS will ensure that the CCFs accurately reflect banking organizations' actual experiences with respect to commitments.

Nevertheless, we set forth below our preliminary concerns with respect to: (i) the data that the Basel Committee has requested under the QIS for purposes of calibrating the CCFs; (ii) the CCFs proposed in the Second Consultation for commitments to retail and wholesale counterparties; (iii) the potential differentiation of CCFs for off-balance sheet commitments based on product type; and (iv) the application of the CCFs to other exposure metrics, including the Basel III leverage ratio.

a. QIS Calibrations

Given that the Basel Committee plans to calibrate the CCF for unconditionally cancellable retail exposures based on the QIS, we believe it is important to highlight a potential flaw with the data being collected that may result in significant miscalibration of the CCF. Specifically, institutions are instructed to calculate a portion of their QIS submission for off-balance sheet commitments (Panel A3 on the BB SA additional worksheet) by examining defaults to compare the charged off amount to the amount of outstandings from 12 months prior. This appears to be intended to capture the amount of draws associated with a defaulted exposure prior to charge off. However, we note that the Basel Committee's 12-month lookback approach for every default does not accurately reflect the nature of many charged off accounts. Rather, a proper calibration should reflect the fact that defaults will be distributed evenly across a 12-month horizon, and only a small fraction of charge-offs will take the full 12 months. Balances of accounts that charge off earlier do not increase as much because typically they are restricted and have less time over which to increase their usage. As such, average future draws for loans that charge off *exactly* 12 months after a point in time will be higher than average future draws of loans that charge off *over* a 12-month period. The assumption that all accounts will have a full 12-month drawdown period prior to charge off represents an unrealistic worst case scenario that will overstate the amount of increase. Proper calibration should take all active accounts at a point in time, examine all charged off accounts over the ensuing 12 months and compare the changes in the account balances from the starting point to the point at which they were charged off. We respectfully submit that this more appropriately calibrated methodology would more accurately reflect the purpose underlying this requirement.

b. Calibration of CCFs

The Associations continue to believe that the Basel Committee's range of applicable CCFs (which is higher than the current 0 percent CCF) for unconditionally cancellable commitments for retail counterparties is inappropriate in light of the fact that banking organizations are permitted to eliminate these exposures entirely at any time, and, with respect to retail commitments (*i.e.*, credit cards and home equity lines of credit) in the United States, have in fact done so in the past.²³ Historical data demonstrates that banking organizations have

²³ TCH Comment Letter, at 13-14.

unilaterally cancelled these commitments and eliminated the risk during periods of stress. For example, the Federal Reserve Bank of New York Quarterly Report on Household Debt and Credit shows that limits on credit card lines of credit fell by 12 percent during the recent recession in the United States.²⁴

Consistent with the Basel II and Second Consultation's definition of unconditionally cancellable, which permits national discretion to treat retail commitments "as unconditionally cancellable if the terms permit the banking organization to cancel them to the full extent allowable under consumer protection and related legislation," many of the applicable retail commitment products provide banking organizations with complete contractual authority to terminate the exposure.²⁵ For example, credit card commitments are governed by contractual agreements between a banking organization and the borrower, and almost all allow the banking organization to cancel at any time without regulatory restriction. Likewise, nearly all home equity lines of credit provide the banking organization with the contractual ability to cancel or terminate the line of credit at any time, subject to certain limited restrictions.²⁶ We are currently working on a separate submission to the Basel Committee the results of further data analysis with respect to these issues after the submission of this letter.

We further believe that undrawn balances for unconditionally cancellable credit card commitments in the United States tend to be larger than those outside of the United States with a lower total drawn balance. As a result, the imposition of any inappropriately calibrated CCF to such commitments will disproportionately impact U.S. banking organizations irrespective of the fact that such amounts are less likely to be actually drawn by customers and therefore may ultimately hamper this critical provision of credit to consumers, thereby dampening an important driver of macroeconomic growth.

The Associations further note that wholesale commitments are solely governed by the contractual agreement between a banking organization and its borrower and can be cancelled without regulatory restriction. Therefore, we likewise believe that the elimination of the lower CCF for unconditionally cancellable wholesale commitments is unwarranted.

c. Differentiation of CCF by Product

The Associations note that the actual drawdown rates for off-balance sheet commitments often vary significantly by product. As such, the application of a "one-size fits all" CCF to all off-balance sheet commitments will result in capital charges that are too high for products with lower drawdown rates. To reduce any potential inequity, we recommend that the Basel Committee differentiate the applicable CCF by product. For example, certain

²⁴ Federal Reserve Bank of New York, Quarterly Report on Household Debt and Credit, at 7 (November 2014), available at: http://www.newyorkfed.org/householdcredit/2014-q3/data/pdf/HHDC_2014Q3.pdf.

²⁵ Second Consultation, ¶ 69, at 39; Basel II, ¶ 83, at 26.

²⁶ Indeed, the U.S. Federal banking agencies have always treated these exposures as unconditionally cancellable for purposes of the U.S. capital rules. Federal Reserve, OCC, FDIC, Frequently Asked Questions on the Regulatory Capital Rule, FAQ 6 (March 31, 2015), available at: <https://www.fdic.gov/regulations/capital/capital/faq.pdf>.

conditional commitments such as wealth management products and other lines of credit that require customers to post collateral or additional collateral at the time they drawdown on the commitment have far lower drawdown rates than most other types of commitments because borrowers are far less likely to draw on such commitments when facing liquidity constraints due to the requirement to post additional collateral. In such circumstances borrowers are far more likely to pay down or eliminate the commitment to free up readily marketable liquid assets than to post such assets as collateral to draw on the commitment. Likewise, drawdowns on commitments to mutual funds have historically not been higher than 10 percent. In addition, revolving lines of credit are also less likely to be entirely drawn by borrowers than term loans, which have fixed loan disbursements. In light of the historically lower drawdown rates for these types of commitments, such commitments merit application of separate and reduced CCFs.

d. Impacts on other exposure metrics, including the Basel III Leverage Ratio “Total Exposure Measure”

We are most troubled by the fact that if these same CCFs are ultimately incorporated into the current Basel III internationally agreed leverage ratio exposure measure, leverage ratio capital requirements would necessarily increase. This would have the undeniable effect of making the already blunt leverage ratio (which, unlike the risk-weighted assets calculation, does not provide any risk sensitivity for commitments that are converted into on-balance sheet equivalents by the operation of CCFs) more binding and further departing from the Basel Committee’s stated policy of the leverage ratio acting as a back-stop measure to risk-weighted asset calculations. Of course, this would be even more problematic in jurisdictions, like the United States, that have adopted supplementary leverage ratio requirement higher than the Basel Committee’s three percent calibration on a super-equivalent basis.

The Associations continue to believe that regulatory initiatives that increase the likelihood that the leverage ratio will become *the* binding constraint for many banking organizations are misguided—at best. In light of the inherent risk insensitivity of leverage-based capital ratios—a defect that cannot be fixed by adjusting risk-weights and refining models—leverage should only be used as a backstop. The practical impacts of risk-insensitive leverage standards are exacerbated by the high proportion of assets that the LCR forces large banking organizations to hold as high-quality liquid assets. Reliance on leverage standards as more than a backstop, in our view, should be eliminated or at least reduced, not increased. If adopted as part of the leverage ratio, the recalibration of the CCFs for off-balance sheet commitments higher would further exacerbate the defect of the leverage ratio.

Furthermore, these CCF changes would also negatively affect other metrics that incorporate the Basel III total leverage exposure measure, including the GSIB surcharge and the Financial Stability Board’s (“FSB”) proposed total loss absorbing capacity (“TLAC”) standards. In addition, the Basel Committee’s large exposures framework applies the Standardized Approach’s CCFs for purposes of calculating single counterparty credit exposure. Unlike the risk-weighted assets calculation, which risk-weights each exposure after the CCF is applied (for example, 75 percent for investment grade corporate exposures), each of the exposures

discussed above would incorporate the entirety of the exposure in their respective calculations.²⁷

As such, to the extent the Basel Committee adopts revised CCFs for the risk-weighted capital calculations under the Standardized Approach, we would recommend that the Basel Committee consider not importing the revised CCFs into the total exposure measure used for the leverage ratio and other provisions which use the same measure. Alternatively, the Basel Committee and national regulators should consider properly recalibrating the leverage ratio requirement and the other frameworks that rely on the total exposure to take into account and mitigate the impact of these CCF revisions. This would ensure that the Basel Committee revisions to the Standardized Approach are consistent with its stated goal of not increasing overall capital requirements for banking organizations.

4. Credit Risk Mitigation Framework

As noted above, the Associations support many of the Basel Committee's proposed revisions to the credit risk mitigation framework for SFTs. In this regard, we note that, in referring to the revisions, the Second Consultation appears to use the terms "collateralized transactions," which include SFTs, and "repo-style" transactions that are a subset of SFTs, interchangeably.²⁸ The Associations note that other collateralized transactions, such as margin loans, have risk profiles that are essentially identical to that of repo-style transactions, and are also impacted by correlation and diversification effects of securities within a netting set. To avoid disincentivizing transactions with similar risk profiles, we respectfully request that the Basel Committee clarify that its revised credit risk mitigation framework is applicable to all SFTs, which as defined under the Basel III Accord, includes both repo-style transactions and margin loans. In this respect, we note that the operative text in the revised Standardized Approach appears to correctly refer to all "collateralized transactions."

In order to further strengthen the Second Consultation's credit risk mitigation framework, the Associations also recommend that the Basel Committee modify these provisions to: (i) permit banking organizations to choose between the simple approach and the comprehensive approach by transaction type or exposure; (ii) change the recognition of smaller securities issuances for SFT netting set purposes; (iii) recalibrate the equity and corporate debt haircuts; and (iv) recognize non-investment grade corporate debt securities as eligible financial collateral and reframe the proper cutoff for the inclusion of certain securitization securities as eligible financial collateral. We believe that, as set forth in more detail below, these modifications will ensure that the framework is more appropriately calibrated and risk sensitive.

a. Choice Between Simple and Comprehensive Approaches

The current Standardized Approach provides that banking organizations may opt for either the simple or comprehensive approach to the credit risk mitigation framework for

²⁷ The Associations note that this issue becomes more pronounced in jurisdictions that have introduced a super-equivalent leverage ratio applicable to certain banking organizations.

²⁸ Compare Second Consultation, ¶ 117, at 47 ("collateralised transactions") with Section 2.1, at 19 ("Revised methodology for repo-style transactions").

purposes of exposures to the banking book, but that they may not operate under both approaches.²⁹ The Second Consultation would retain this restriction. We believe that, under certain circumstances, it may be more appropriate for banking organizations to vary the credit risk mitigation approach used by transaction or exposure type based on the makeup of the banking organization's exposures. Where a banking organization has few of a certain type of exposure it may be more expedient and less burdensome to rely on the simple approach, whereas for multiple or more complex exposures, the comprehensive approach may be more appropriate. We believe that the flexibility to adopt either approach by exposure type would reduce the burden on banking organizations that do not need the comprehensive approach for all exposures within the banking book, but improve flexibility for the transaction types that require additional sensitivity. This flexibility would be consistent with the Basel Committee's goals of balancing risk sensitivity and complexity in the Standardized Approach.

b. Exclusion of Smaller Securities Issuances from Netting Set

In order to further strengthen the credit risk mitigation framework, the Associations recommend an adjustment to the methodology proposed by the Basel Committee for the exclusion of smaller securities issuances from the SFT netting set. As currently designed, securities issuances are excluded if they represent less than one-tenth, or 10 percent of the value of the largest securities issuance, with the intent of offsetting the impact of smaller securities issuances that may not reflect true portfolio diversification. However, this approach can and often may lead to an unwarranted distortion of data. This is especially true within netting sets that include sovereign debt securities, such as U.S. Treasuries, where there may be a small number of very high value trades that can obscure other securities issuances which would otherwise reflect appropriate levels of diversification. In order to mitigate this limitation, the Associations recommend that minimum size be defined not on the basis of the largest securities issuance, but rather as a percentage of the average size of all securities issuances within the netting set (20 percent, for example). This would result in a more proportional view of the effect of smaller securities issuances within the formula for SFTs that is nonetheless consistent with the Basel Committee's underlying policy goals.

c. Haircuts for Equity and Corporate Debt Securities

The Associations believe that the credit risk mitigation framework's haircuts for equity and corporate debt securities remain too high relative to their overall risk profile, may unduly penalize institutions that accept such collateral, and are unwarranted in light of the cumulative impact of numerous capital and liquidity regulations that affect SFTs. More specifically, the Associations note that the proposed haircuts remain too high relative to the market haircuts on equities as set forth in data released by the FSB and the Federal Reserve Bank of New York (see below), particularly given that many of the Basel Committee's other capital and liquidity metrics provide similar treatment to exchange-traded common equity and corporate debt securities.

²⁹ Basel II, ¶ 121.

i. Available Data on Market-Observed Equity Haircuts

To begin, the Associations note that the FSB recently conducted a study of the historical price volatility of different asset classes in order to calibrate minimum haircuts.³⁰ As shown below in **Table 1**, the study, which is based on historical data of daily returns and uses a methodology consistent with Basel III, illustrates that the haircuts outlined in the Second Consultation are high relative to the FSB’s market-observed equity haircuts.³¹ Under the study, the FSB found typical market equity haircuts of 13.8 percent for national exchange listed equities and 17.5 percent for other equities, each considerably below the proposed haircuts for equity securities under the Second Consultation (20 percent of equities listed on a national exchange and 30 percent for other equities). Similarly, as shown below in **Table 2**, the Second Consultation proposes significantly higher haircuts for corporate debt securities when compared to the haircuts suggested by the FSB study.³²

Table 1. FSB Equity Haircuts versus the Existing Standardized Approach and the Second Consultation

	Existing Standardized Approach Equity Haircuts (%)	Revised Standardized Approach Equity Haircuts (%)	FSB Market Observed Equity Haircuts (%)
National exchanged listed equities	15.0	20.0	13.8
Other listed equities	25.0	30.0	17.5

Table 2. FSB Corporate Bond Haircuts versus the Second Consultation’s CR-based and Non-CR Based

Residual Maturity	Revised Standardized Approach Non-Sovereign Haircuts, Non-Ratings Based (%)	Revised Standardized Approach Non-Sovereign Haircuts, Ratings-Based (%)	FSB Market Observed Corporate Bond Haircuts (%)
> 1 year and ≤ 3 years	4.0	3.0 – 4.0	2.2

³⁰ See Strengthening Oversight and Regulation of Shadow Banking: Regulatory framework for haircuts on non-centrally cleared securities financing transactions (Oct. 2014). For equities listed on a national exchange, the weighted-average of haircuts estimated is based on the FTSE 100, Stoxx Europe 50, S&P 500 and Nikkei 225. For other equity indices, the weighted-average of haircuts estimated is based on FTSE SmallCap, FTSE Europe SmallCap, S&P 600 SmallCap and TSE Mothers indices.

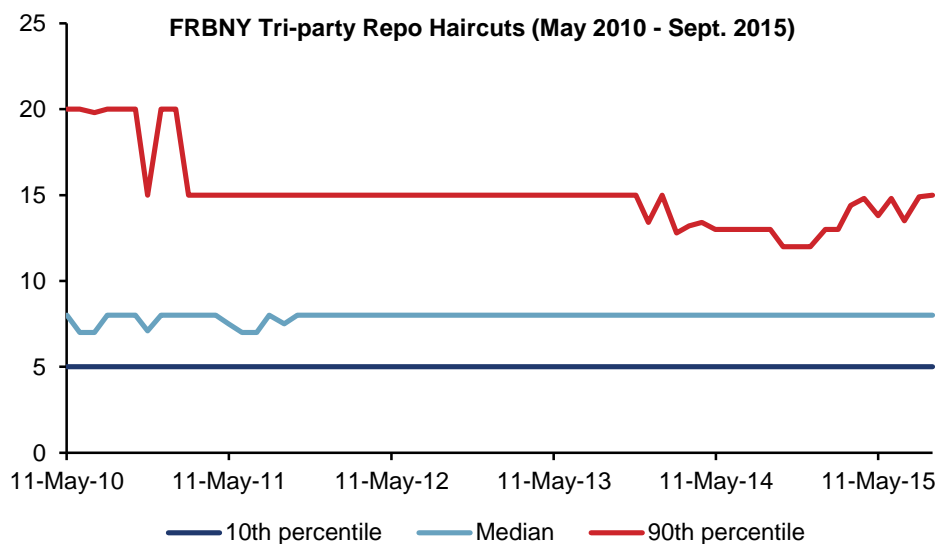
³¹ The estimate methodology used a 99th percentile of expected loss and a holding period of 10 days, measured over a stressed time horizon (either 5 years of historical data or the period since end-June 2008, whichever was greater). The Basel III framework requires a 10-business-day holding period for standard supervisory haircuts (paragraph 151) and a 99th confidence interval for own-estimate haircuts (paragraph 156).

³² For example, the haircut for corporate bonds with a residual maturity between 5 and 10 years is the weighted-average of haircuts estimated based on the Merrill Lynch 5-10 Year Corporate Bond Index for U.S. dollars, euro, pound sterling, and Japanese yen.

> 3 years and ≤ 5 years	6.0	4.0 – 6.0	
> 5 years and ≤ 10 years	12.0	6.0 – 12.0	4.5
> 10 years	20.0	12.0 – 20.0	5.9

Furthermore, the haircuts outlined in the Second Consultation are higher than the market haircuts for equity securities observed under tri-party repo data available from the Federal Reserve Bank of New York.³³ More specifically, Table 3 below illustrates that the median haircuts for repo-style transactions between May 2010 and September 2015 were consistently and substantially lower than the haircuts proposed in the Second Consultations for both equities listed on a national exchange and other listed equities. The median haircut was 8 percent of both equities listed on a national exchange and those listed on other exchanges, and the highest haircut in the data series (representing the 90th percentile of trade haircuts between May 2010 and January 2011) for each of national exchange listed equities and all other listed equities, was 20 percent. Available data thus indicates that lower haircuts are appropriate for both types of equity securities.

Table 3. FRBNY Tri-Party Repo Data



- ii. The Basel Committee’s Previous Determination of the Comparability of Exchange Traded Common Equity and Corporate Debt Securities.

In addition, the Basel Committee’s recently revised NSFR provides that SFTs secured by exchange-traded common equity shares that are not issued by financial institutions are assigned the same required stable funding factor (50 percent) as most investment grade corporate debt securities. The LCR similarly treats investment grade corporate debt securities

³³ Federal Reserve Bank of New York, Tri-party Repo Statistical Data, available at: https://www.newyorkfed.org/banking/tpr_infr_reform_data.htm.

and exchange-traded common equity as Level 2B liquid assets, subject to the same haircuts. Given these previous determinations of comparability by the Basel Committee, we believe that the collateral haircuts for equity securities in the revised credit risk mitigation framework should be aligned with those of corporate debt securities.

iii. Cumulative Impact of Numerous Capital and Liquidity Regulations

Furthermore, we submit that the relatively high haircuts proposed in the Second Consultation are unwarranted given the suite of existing capital and liquidity regulations that affect SFTs, including the NSFR, the LCR, the GSIB surcharge, and the Basel III leverage ratio.³⁴ In light of these other standards, the minimum haircuts proposed for SFTs would require banking organizations to hold excessive capital on certain SFTs where they intend to provide financing to non-banks. If these haircuts are retained, the haircuts may entirely offset the positive impacts from the revised credit risk mitigation framework noted above for SFTs. At a minimum, the relatively high haircuts proposed in the Second Consultation fail to consider the cumulative effect of the regulatory framework for capital and liquidity. When the impacts of other applicable regulatory requirements are taken into account, we believe the combined regulatory impact on SFTs is disproportionate to the risk inherent in these transactions, and higher haircuts would thus require banking organizations to hold more capital than is necessary to achieve the objectives of the Second Consultation and could negatively impact pricing and the ability to meet customer demand. The Associations respectfully suggest that equity haircuts be revised lower to align more closely with the available data on market-observed equity haircuts discussed above.

d. *Eligible Financial Collateral*

i. Non-Investment Grade Corporate Debt Securities

We note that the credit risk mitigation framework continues to entirely exclude non-investment grade corporate debt securities from the definition of eligible financial collateral. The exclusion of non-investment grade securities ignores the fact that such securities do provide some credit risk mitigation. The stable performance of non-investment grade bonds, even during stressed periods, warrants reconsideration of their eligibility and is validated based on historical price data. For example, data indicates that the historical price volatility of the largest non-investment grade corporate bond exchange-traded funds (“ETFs”) warrants not only their inclusion, but a haircut below 15 percent.

The table below illustrates the historical price volatility of the iShares iBoxx High Yield Corporate Bond Fund (“HYG”) and the SPDR Barclays Capital High Yield Bond ETF (“HYB”)

³⁴ GSIBs are also required to hold additional capital for their SFT holdings under the GSIB capital buffer across several inputs, including the size indicator (total leverage exposure), the interconnectedness indicator (for SFTs with financial institution counterparties), and cross-jurisdictional indicator (for SFTs with foreign counterparties). SFTs are further penalized by their inclusion in the Basel III leverage ratio, which requires banks to include SFT receivables in the exposure measure plus an add-on for counterparty credit risk.

ETFs where their daily price movements were examined from 2007 to measure the historical price volatility over a rolling 10-day holding period, at 90, 95 and 99 percent confidence intervals.³⁵ Across all negative 10-day moves, 90 percent of the time, the prices of HYG and HYB declined by less than 3.7 and 3.9 percent, respectively. Similarly, across all negative 10-day moves, 99 percent of the time, HYG and HYB declined by less than 12.1 and 12.2 percent, respectively.

Neg. Days Only	HYG (Non-IG Bonds)	HYB (Non-IG Bonds)
90th Percentile	-3.7%	-3.9%
95th Percentile	-5.5%	-6.0%
99th Percentile	-12.1%	-12.2%
Median	-1.1%	-1.1%

Accordingly, with properly calibrated haircuts, we believe that non-investment corporate debt securities should be recognized as having some collateral benefit. In light of the relative novelty in recognizing non-investment grade securities as collateral, we propose that non-investment grade securities receive a 25 percent haircut to conservatively account for potential price declines across even the most stressed conditions. A 25 percent haircut would be nearly double the actual price volatility of these securities, and could be revisited in the future for continued appropriateness.

ii. Securitizations

The current Standardized Approach, as amended by the Basel III accord, provides for the recognition of securitization securities that are rated BBB- or greater as eligible financial collateral.³⁶ For jurisdictions that cannot rely on external credit ratings, the Second Consultation proposes to modify the threshold for the inclusion of securitization securities as eligible financial collateral to solely include those that have a risk weight of less than 100 percent under the revised securitization framework. Jurisdictions that adopt an external credit ratings approach are permitted to include securitizations securities that receive an external credit rating of BBB- or greater. Although this revision appears designed to reflect the Basel Committee's recent revisions to the framework for risk-weighting securitization exposures,³⁷ the reliance on the 100 percent risk-weighting threshold will result in an immediate disparity between jurisdictions that allow the use of external credit ratings approach and those that do not because BBB- rated securitization securities that are eligible financial collateral are risk-weighted at least 120 percent under the revised securitization framework and may be risk-

³⁵ The Basel III framework requires a 10-business-day holding period for standard supervisory haircuts and a 99th percentile confidence interval for own-estimate haircuts.

³⁶ Basel Committee, Basel III: A global regulatory framework for more resilient banks and banking systems (revised June 2011), available at: <http://www.bis.org/publ/bcbs189.pdf>.

³⁷ Basel Committee, Basel III Document: Revisions to the Securitization Framework ("Securitization Framework") (December 11, 2014), available at: <http://www.bis.org/bcbs/publ/d303.pdf>.

weighted as high as 420 percent.³⁸ Moreover, we note that under the revised securitization framework, due to the conservative assumptions set forth in the framework, the risk-weighting calculations under the standardized approach for securitization exposures nearly always result in a higher risk-weighting than under the external credit ratings approach,³⁹ further exacerbating the inequity inherent in a framework that treats the same risk differently depending on the jurisdiction of organization of the banking organization calculating the relevant risk-weighted asset amount.⁴⁰

To address this inequity, we recommend that the Basel Committee adopt an “investment grade” standard for this purpose. This would align with other exposures that are treated as eligible financial collateral (such as corporate debt securities) and will reduce the inequity that a flat 100 percent securitization exposure risk-weight has with the range of risk-weights for BBB- securitization exposures under the revised securitization framework. As noted above in Part III.B.2, these determinations can be subject to strict supervisory criteria that can vary by asset class.

5. Public Sector Entities

The Associations believe that a separate, differentiated treatment for exposures to sovereign entities, public sector entities (“PSEs”), and multilateral development banks (“MDBs”) should also be applicable with respect to entities that serve a public policy function rather than operating as a commercial interest. This would include certain sovereign wealth funds that typically have the implicit support of the respective sovereign or PSE. These sovereign wealth funds are commonly financed by balance of payments surpluses, funds accumulated by central banks during foreign currency operations, the proceeds of privatizations of state-owned enterprises, fiscal surpluses and receipts from commodity exports. In light of the fact that these funds are typically owned and managed by the sovereign, the Standardized Approach should allow exposures to sovereign wealth funds to be treated as exposures to the sovereign itself to determine a base risk-weighting in accordance with the treatment afforded PSEs. To build on such base risk-weighting, similar to the approach for exposures to MDBs, the applicable risk-weight for exposures to sovereign wealth funds could then be evaluated based on the presence or absence of strict statutory lending requirements and conservative financial policies, which would include among other conditions a structured approval process, internal creditworthiness and risk concentration limits (per country, sector, individual exposure, and credit category), large exposures approval by the board or a committee of the board, fixed repayment schedules, effective monitoring of use of proceeds, status review process, and

³⁸ Id. at 21.

³⁹ Id. at 78-87.

⁴⁰ As noted above in Part II.A., the inability to review the entirety of Basel Committee’s proposed revisions to the calculation of risk-weighted assets deprives interested parties with the benefit of considering the potential cumulative and/or synergistic effects of each of the Basel Committee’s proposals taken together. In the case of the inclusion of securitization exposures as eligible financial collateral, we note that because the securitization framework was previously finalized we were unable at that time to comment on the potential usage of the risk-weights under the revised securitization framework in the credit risk mitigation framework and likewise cannot comment on that already finalized framework now.

rigorous assessment of risk and provisioning to loan loss reserve. This treatment would not be afforded to state-owned commercial interests.

6. Short-Term Exposures to Banking Organizations

The Second Consultation proposes to maintain the preferential risk-weighting for short-term exposures to banking organizations so as to not “negatively impact market liquidity in interbank markets.” To receive the short-term preferential risk-weighting, the exposure is required to be three months or less. We believe that this three-month limitation is inconsistent with the NSFR’s treatment of short-term exposures that are eligible for available stable funding (“**ASF**”) treatment, which, depending on the asset, must have a duration of at least six months to receive partial credit and at least one year to receive full credit. Under the NSFR, short-term exposures to banking organizations of six months or more receive a 50 percent ASF factor, whereas those that are three months or less do not receive any ASF treatment.⁴¹ Accordingly, as banking organizations extend funding terms in response to the NSFR, they will be penalized under the revised standardized approach with a higher risk-weighting. To align the incentives under the NSFR, we recommend that the Basel Committee align the short-term bank exposure tenor to those that are eligible for greater than 0 percent ASF within the NSFR and extend the definition of “short-term” to 12 months. This change would have the added benefit of also aligning with the definition used under both U.S. GAAP and IFRS, as well as the definition used in TLAC.

7. Currency Mismatch Add-On

The Second Consultation would expand the application of the First Consultation’s currency mismatch add-on to apply to wholesale, retail, and real estate “unhedged” exposures where the lending currency differs from the borrower’s “main source of income,” a concept that is not defined in the Proposal. We believe that this add-on is not justified because it has the effect of ignoring the role of prudent underwriting by banking organizations in favor of the addition of a large, blunt risk-weight add-on that punitively assumes a substantial absence of convertibility between any two currencies—a factor that would be taken into account in any prudent underwriting of a loan exposure. The Associations note that the material foreign exchange risk of an obligor is one of many elements of the credit risk of such obligor that are considered as part of the broader credit risk assessment undertaken as part of the underwriting for each exposure. Given that banking organizations consider material foreign exchange exposures as part of a borrower’s credit risk, a separate and specific add-on for all foreign exchange exposure under the Standardized Approach is not warranted.

In addition, with respect to the applicability of the add-on, the Second Consultation does not specify whether “main source of income” is intended to signify, for example, the largest source of income or whether there can be more than one main source for companies with significant income derived from in a number of different currencies. This is of particular consequence for exposures to multinational corporations with a diversified business model spanning many international locations. The Second Consultation’s explanation of the

⁴¹ Basel Committee, Basel III: Net Stable Funding Ratio (October 2014), available at: <http://www.bis.org/bcbs/publ/d295.pdf>.

proposed 50 percent risk-weight add-on also does not specifically address whether the add-on should apply to every exposure to such counterparties (including debt securities, secured funding transactions, and loans) or whether it should apply solely to lending exposures. The Second Consultation further fails to specifically consider exposures that are guaranteed and specify whether this add-on would be applicable to such exposures. We request that these ambiguities be appropriately addressed in the final framework to be adopted by the Basel Committee.

Furthermore, the introduction of a currency mismatch add-on may introduce significant operational complexity for banking organizations who may not be able to readily determine whether a company has any natural cash flows in the currency of the loan apart from specific due diligence on the entity which may be at a significant cost and can typically only occur as a result of a typical lending relationship as opposed to an investment in debt securities. While the proposed standard may be suitable for loan exposures to small and medium entities, where a banking organization can more readily perform cash flow due diligence, for large multinational firms it becomes a practical impossibility, potentially requiring a country-by-country examination of the income or revenue of a given borrower. For wholesale borrowers in particular, it may be extremely impracticable for banking organizations to determine whether the mismatch would apply, as much of the required information will likely not be available to banking organizations.

8. Commercial Real Estate Exposures

While we support much of the Basel Committee's proposed revision to the treatment of commercial real estate, including the introduction of an LTV ratio that is based on the value at the time of origination, the Associations are concerned that the Second Consultation does not address whether the real estate exposure risk-weighting would apply to loans that include real property as collateral, but where the purpose of the loan was not to finance or secure the particular collateral property. For example, some commercial and industrial loans may include real property as an element of the collateral supporting the obligation, but the purpose of the loan was not to finance the acquisition or development of such property and the repayment of the loan is not materially dependent on any cash flows associated with the real property collateral. Under a literal reading of the Second Consultation, it appears that the real estate exposure risk-weighting may apply to such loans.

In order to appropriately differentiate such loans from other commercial real estate exposures that would properly fall within the definition proposed in the Second Consultation, the experience of the U.S. Federal banking agencies may provide a useful guide. The U.S. Federal banking agencies' "abundance of caution" guidance for real estate appraisals provides that real estate taken as additional collateral or used as a basis for granting more favorable terms is seen in its more traditional role as collateral protection and not as the basis for the financing.⁴² Under this guidance, the institution must document that the extension of credit is well-supported by income or other collateral of the borrower and that the real estate is being taken as additional collateral. The incorporation of standards that are similar to this guidance would help eliminate the potentially narrow interpretations in the Second

⁴² See, e.g., 12 C.F.R. Part 34 (OCC); Part 225, Subpart F (Federal Reserve); and Part 323 (FDIC).

Consultation and should assist the Basel Committee in more clearly defining the class of exposures that fall within the real estate exposure category.

9. Land Acquisition, Development, and Construction Exposures

Consistent with the First Consultation, the Second Consultation would introduce a 150 percent risk-weight for all land acquisition, development, and construction (“ADC”) exposures. We are concerned that the Second Consultation’s flat 150 percent risk weight is overly prescriptive and fails to take into consideration the varying risk profiles of the entities that receive ADC loans. Indeed, certain borrowers have low leverage, highly liquid balance sheets, and many ADC loans to these borrowers often have lower LTV ratios. We believe that ADC loans to these lower-risk borrowers should be afforded a lower risk-weighting. For example, under the U.S. Standardized Approach, a real estate construction loan with an LTV ratio of less than 80 percent, where the borrower has contributed at least 15 percent of the capital for the project with on-balance sheet liquidity (exclusive of the funding received under the loan) and remains the developer of the project for the life of the project, is eligible for a lower risk-weight.⁴³ This approach appropriately takes objective risk factors into account and rejects a one-size fits all approach that could harm lower-risk borrowers. At the very least, we request that the Basel Committee permit national discretion so that supervisors can consider characteristics of local underwriting practices to set risk-weights for these loans.

10. Equity and Subordinated Debt Exposures

As explained in the First Consultation, the current Standardized Approach does not apply a distinct risk-weighting treatment for exposures to the equity or subordinated debt of corporate exposures.⁴⁴ To enhance the risk sensitivity of the framework and to more closely align with the Advanced Approach, the First Consultation proposed to apply a 250 percent risk-weight for subordinated debt and capital instruments other than equities, a 300 percent risk-weight for publicly traded equities, and a 400 percent risk-weight for others.⁴⁵ In response to commenters’ concerns that the First Consultation’s approach was unduly punitive and did not recognize the fact that the current Advanced Approach’s framework provided national discretion to introduce a materiality threshold and exclude certain equity exposures, the Second Consultation proposes a 250 percent risk-weighting for equity exposures that are not subject to a regulatory capital deduction and a 150 percent risk-weighting for subordinated debt and other capital instruments. Although we appreciate the Basel Committee’s proposed reduction in the applicable risk-weights for equity and subordinated debt exposures, we believe that the Basel Committee should continue to provide national discretion for supervisory authorities to provide for lower risk-weights in certain circumstances because, for certain exposures, the 250 percent risk-weight may nevertheless be unduly punitive.

⁴³ See 12 C.F.R. 3.2; 217.2; 324.2.

⁴⁴ The Associations have assumed that this exposure category would not cover equity exposures to sovereigns, PSEs or MBDs.

⁴⁵ Second Consultation, at 8.

Specifically, similar to the current Advanced Approach, we believe that the Basel Committee should continue to provide for national discretion to provide for a lower risk-weight for banking organizations that have non-significant equity exposures that are not subject to an equity capital deduction.⁴⁶ We note that in certain jurisdictions, such as the United States, a banking organization's ability to hold the equity securities of a company is strictly limited and generally requires it to hold the securities for business rather than investment purposes. Given these strict investment limitations and the fact that the Advanced Approach's materiality threshold limits the amount of holdings that are eligible for the lower risk-weight, we believe that the Basel Committee should provide for national discretion to apply these lower risk-weights.

Likewise, we note that the current Advanced Approach similarly provides national discretion to provide preferential risk-weights for equity exposures made under "legislated programmes," subject to certain limitations.⁴⁷ Many jurisdictions, including the United States, have legislation that is designed to promote investment in the equity of community development or other organizations. These entities are currently eligible for a lower risk-weight subject to certain requirements of the national regulator, which would not be subject to such a deduction. The application of the 250 percent risk-weight to such exposures would unduly penalize banking organizations that, in accordance with these national goals, seek to invest in organizations promoting public development. Accordingly, to permit the continued incentivizing of these investments, we request that the Basel Committee provide sufficient national discretion to allow for the preferential risk-weighting of equity exposures to community development or other public interest organizations.

Finally, we believe that the Basel Committee should permit national authorities to apply a preferential risk-weighting for certain equity exposures that are part of a "hedged pair" (that is, two equity exposures that form an effective hedge) to allow the banking organization to risk-weight only the effective and ineffective portions of a hedged pair rather than the entire adjusted carrying value of each exposure making up the pair. Under such a framework, the Basel Committee can require an effective hedge (*i.e.*, among other things, that the exposures generally have equivalent remaining maturities, documentation specifying the effectiveness of the hedge, and in fact be effective).⁴⁸ This would ensure that effectively hedged exposures (that are subject to stringent oversight and supervisory requirements) are not provided with an unduly punitive risk-weighting.

11. Credit Default Swaps

In the First Consultation, the Basel Committee proposed to no longer recognize credit derivatives that do not specify restructurings as a covered credit event. The Second Consultation notes that the Basel Committee is reviewing the terms of credit derivatives that are eligible for full recognition as credit risk mitigants, and notes that the Basel Committee

⁴⁶ Basel II, ¶ 358.

⁴⁷ Basel II, ¶ 357.

⁴⁸ We note that the United States has adopted such an approach to permit a reduced risk-weighting in such circumstances. See 12 C.F.R. 3.52(b)(3)(ii); 217.52(b)(3)(ii); 324.52(b)(3)(ii).

understands that U.S. credit derivatives do not contain restructuring clauses due to market practice because virtually no restructurings occur outside of the U.S. bankruptcy process. We continue to stress that the exclusion of credit derivatives without restructuring clauses would unduly affect the holders of U.S. credit derivatives. As noted in the TCH Comment Letter, the Standard North American Corporate Contract (“**SNAC**”) for U.S. credit derivative confirmations does not require restructuring clauses.⁴⁹ Rather, these credit derivatives and other commercial agreements rely on “failure to pay” and “bankruptcy” clauses that are intended to capture the most applicable credit events in the United States.

In contrast to many other jurisdictions, debt restructurings, where a company is truly experiencing a credit event that would otherwise trigger bankruptcy, are uncommon in the United States. Rather, nearly all restructurings occur in the context of Chapter 11 of the U.S. Bankruptcy Code—which, unlike the formal insolvency laws of many other jurisdictions, which typically involve liquidation proceedings, specifically creates a court-administered reorganization and restructuring process—and therefore fall within the bankruptcy clause for such agreements. Moreover, in the United States, bond indentures typically require 100 percent of holders to consent to change terms that substantively affect the economic value of the bonds. Thus, a non-bankruptcy debt restructuring (that is, a restructuring outside of the context of bankruptcy) is almost impossible if the consent of all bondholders is required. If a bondholder refuses to consent to the restructuring, the borrower will be legally required to repay the bond, default (which would trigger a credit derivative’s “failure to pay clause”), or declare bankruptcy to restructure the debt (which would trigger a credit derivative’s “bankruptcy clause”). Failure to make proper allowance for different market structures and conventions would unduly punish U.S. banking organizations without any justification.

In addition to the harsh and unwarranted effect on U.S. banking organizations, we note that many non-U.S. banking institutions may also enter into credit derivatives governed by the SNAC. As a result, the wholesale exclusion of these credit derivatives from recognition as a credit risk mitigant may also hamper foreign banking organizations that service customers requesting products that may be governed by U.S. law.

12. Core Market Participant Exemption

The Second Consultation states that the Basel Committee is currently reviewing the continued relevance of the core market participant exemption to the standardized approach’s 20 percent risk-weight floor under the credit risk mitigation framework. As set forth in The Clearing House’s comment letter on the First Consultation, the Associations support the elimination of the core market participant exemption due to the disharmonization that arises from the fact that some jurisdictions, and not others, have adopted the exemption.⁵⁰ As a

⁴⁹ The SNAC became the standard CDS contract traded in North America on April 8, 2009. As most restructurings in the United States take place under Chapter 11 of the U.S. Bankruptcy Code, the invocation of which automatically triggers a bankruptcy credit event under any standard CDS confirmation, there is little incremental benefit to the majority of CDS protection buyers from the inclusion of restructuring as a credit event in the United States. <http://www.cdsmodel.com/cdsmodel/assets/cds-model/docs/Standard%20CDS%20Contract%20Specification.pdf>.

⁵⁰ TCH Comment Letter, at 21.

result, capital requirements are effectively reduced in the jurisdictions that have adopted the standard without any positive correlation to the underlying economic risk posed by the institution.

* * *

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The Honorable Michael Gibson
Board of Governors of the Federal Reserve System

The Honorable Scott Alvarez
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ANNEX A

The Clearing House. The Clearing House is a banking association and payments company that is owned by the largest commercial banks and dates back to 1853. The Clearing House Payments Company L.L.C. owns and operates core payments system infrastructure in the United States and is currently working to modernize that infrastructure by building a new, ubiquitous, real-time payment system. The Payments Company is the only private-sector ACH and wire operator in the United States, clearing and settling nearly \$2 trillion in U.S. dollar payments each day, representing half of all commercial ACH and wire volume. Its affiliate, The Clearing House Association L.L.C., is a nonpartisan organization that engages in research, analysis, advocacy and litigation focused on financial regulation that supports a safe, sound and competitive banking system.

The Securities Industry & Financial Markets Association. The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit www.sifma.org.

Financial Services Roundtable. *As advocates for a strong financial future™*, FSR represents 100 integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. FSR member companies provide fuel for America's economic engine, accounting directly for \$98.4 trillion in managed assets, \$1.1 trillion in revenue, and 2.4 million jobs.

ANNEX B

The following matrix provides examples of factors for banking organizations to consider as part of a robust credit risk assessment framework for designated types of instruments. The types of securities included in the matrix require a credit-focused pre-purchase analysis to meet the investment grade standard.

Key Factors	Corporate bonds	Municipal government general obligations	Revenue bonds	Structured securities*
Confirm spread to U.S. Treasuries is consistent with bonds of similar credit quality	X	X	X	X
Confirm risk of default is low and consistent with bonds of similar credit quality	X	X	X	X
Confirm capacity to pay and assess operating and financial performance levels and trends through internal credit analysis and/or other third party analytics, as appropriate for the particular security.....	X	X	X	X
Evaluate the soundness of a municipal’s budgetary position and stability of its tax revenues. Consider debt profile and level of unfunded liabilities, diversity of revenue sources, taxing authority, and management experience .....	.....	X	.....	.....
Understand local demographics/economics. Consider unemployment data, local employers, income indices, and home values.....	.....	X	X	.....
Assess the source and strength of revenue structure for municipal authorities. Consider obligor’s financial condition and reserve levels, annual debt service and debt coverage ratio, credit enhancement, legal covenants, and nature of project.....	.....	.....	X	.....
Understand the class or tranche and its relative position in the securitization structure.....	.....	.....	.....	X
Assess the position in the cash flow waterfall.....	.....	.....	.....	X
Understand loss allocation rules, specific definition of default, the potential impact of performance and market value triggers, and support provided by credit and/or liquidity enhancement.....	.....	.....	.....	X
Evaluate and understand the quality of the underwriting of the underlying collateral as well as any risk concentrations.....	.....	.....	.....	X

Key Factors	Corporate bonds	Municipal government general obligations	Revenue bonds	Structured securities*
Determine whether current underwriting is consistent with the original underwriting underlying the historical performance of the collateral and consider the effect of any changes.....	X
Assess the structural subordination and determine if adequate given current underwriting standards.....	X
Analyze and understand the impact of collateral deterioration on tranche performance and potential credit losses under adverse economic conditions.....	X

***Additional Guidance on Structured Securities Analysis:**

The creditworthiness assessment for an investment security that relies on the cash flows and collateral of the underlying assets for repayment (that is, a structured security) is inherently different from a security that relies on the financial capacity of the issuer for repayment. Therefore, banking organizations should demonstrate an understanding of the features of a structured security that would materially affect its performance and that its risk of loss is low even under adverse economic conditions. Management’s assessment of key factors, such as those provided in this guidance, will be considered a critical component of any structured security evaluation. A banking organization must obtain an understanding of the security’s structure and perform a scenario analysis that evaluates how the security will perform in different default environments. Policies that specifically permit this type of investment should establish appropriate limits, and pre-purchase due diligence processes should consider the impact of such purchases on capital and earnings under a variety of possible scenarios. National supervisors should require banking organizations to understand the effect economic stresses may have on an investment’s cash flows. Various factors can be used to define the stress scenarios. For example, an institution could evaluate the potential impact of changes in economic growth, stock market movements, unemployment, and home values on default and recovery rates. Some institutions have the resources to perform this type of analytical work internally. Generally, analyses of the application of various stress scenarios to a structured security’s cash flow are widely available from third parties. Many of these analyses evaluate the performance of the security in a base case and a moderate and severe stress case environment. Even under severe stress conditions, the stress scenario analysis should determine that the risk of loss is low and full and timely repayment of principal and interest is expected.