

January 19, 2018

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



Re: Basel III Capital Standards – Requests for Clarification

Dear Mr. Coen:

The Institute of International Finance (IIF) is pleased to provide some specific requests for clarification on particular items in the Basel Committee's recently finalized package of Basel III reforms.

After a detailed reading of the final package by our members, we believe there are a number of items that could be enhanced with further guidance on how these standards should be interpreted and applied. Such clarifications are important not only for banks' preparations for implementation, but also to enable the impacts to be accurately tested and assessed.

Accordingly, we have set out a series of specific questions on items in the finalized package, across credit risk, operational risk and the output floor. While we believe this series of items to be quite comprehensive across the package, we stress that it is non-exhaustive, and that additional issues may emerge as the industry proceeds with implementation preparations.

We encourage the Committee to address these both (i) via the publication of a Frequently Asked Questions (FAQ) document, and (ii) in the guidance and instructions for the upcoming Monitoring QIS exercise. As well as providing greater clarity, these steps will enable more transparent and accurate impact assessment (which we believe is essential), and ultimately help towards consistent implementation.

The IIF remains committed to supporting enhancements to the international capital framework, and we view these areas for clarification as an important first step through the Basel III implementation journey of the coming years. We very much appreciate our ongoing interaction with the Committee, and we welcome ongoing dialogue on this important matter. If you have any questions on the issues raised in this letter, please contact myself, Brad Carr (bcarr@iif.com) or Jaime Vazquez (jvazquez@iif.com).

Sincerely,

A handwritten signature in black ink, appearing to read "A. Portilla". The signature is fluid and cursive, with a large initial "A" and "P".

Andrés Portilla
Managing Director, Regulatory Affairs

IIF Specific Requests for Clarification in the Basel III Package, January 19, 2018

1. Credit Risk

1.1 Standardized Approach for Retail Residential Real Estate

Valuations

- Noting the differences in terminology and market practices across jurisdictions, where the term “value at origination” applies, we seek clarity that “at origination” can be defined as being at the time of either the purchase or refinance?
- How frequently can an updated valuation (whether upwards and downwards) of a property be applied?
- Where it is stated that “modifications made to the property that unequivocally increase the property value could also be considered in the LTV value” (paragraph 62¹), is there any guidance as to what modifications would be considered as eligible?
- Where such modifications of unequivocal value are completed, is the ability to reflect the refreshed property value limited to the effect of these improvements? For example, if a property with a previous value of \$400,000 has \$40,000 worth of improvements made (that satisfy the notion of unequivocal added value), and the property market is assessed independently as having added an incremental \$50,000 in the home’s value since the previous valuation, can the valuation be re-assessed now as \$490,000 or \$450,000?
- What is the meaning of the “effective purchase price” as described in footnote 41 (where it is stated that in the case where the mortgage loan is financing the purchase of the property, the value of the property for LTV purposes will not be higher than the effective purchase price)? Is this the same as the contractual purchase price at loan origination? Does this mean inclusive of legal costs? Or could it also be the value at some future date (eg. post loan origination and post modifications later than at origination, the latter as allowed in paragraph 62)?

Categorizations

- Where should Tenant-owned apartment associations (such as those that are common in Sweden and Finland), be categorized?

LTV and Loan-splitting

- Is the ability to apply a 20% RW up to 55% of the property value and 75% RW for the remainder of the loan (paragraph 65) a matter of national discretion, to be decided by the national regulator? We note the potential for discrepancies for banks operating across multiple jurisdictions, if home and host regulators choose different methods.
- Do banks have the choice whether to apply this treatment (paragraph 65) or to apply the ‘standard’ table of RWs (paragraph 64, table 11)?
- It is not clear in the alternate treatment is described (paragraph 65) whether Case 1 and Case 2 are given by way of example, or whether this only applies in those specific circumstances. Case 1 and Case 2 explain the methodology respectively for when a bank has a junior lien and when it has a lien that is pari passu with other banks, but there is no explicit Case covering the situation where a bank has a pari passu lien with other banks and there is also a senior lien. The appropriate treatment might be derived from Case 1 and 2, but it is worth some explicit clarification.

¹ Except where specified, all paragraph and footnote citations are referencing from *Basel III: Finalizing post-crisis reforms*, December 2017, document reference d424.

IIF Specific Requests for Clarification in the Basel III Package, January 19, 2018

Defaulted assets

- The applicable treatment for “buy-to-let” (or “investor”) mortgages does not seem to be explicitly defined; whereas paragraph 92 describes the RW for unsecured and paragraph 93 describes it for owner-occupied (ie. “not materially depend on cash flows”) mortgages, there appears no mention for defaulted “buy-to-let” mortgages.

Interplay with the NSFR

- The existing Net Stable Funding Ratio (NSFR) standard states that “unencumbered residential mortgages with a residual maturity of one year or more that would qualify for a 35% or lower risk weight under Basel II standardized approach for credit risk” are eligible for a 65% Required Stable Funding (RSF) factor (paragraph 41), which is well aligned to the previous Standardized Approach risk-weight treatments. Will this item in the NSFR standard be revisited in light of the new Standardized Approach risk-weights?

1.2 Standardized Approach for non-Retail Asset Classes

Covered Bonds:

- Where requirements for additional collateral are outlined (paragraph 33), it is stated that this may include substitution assets and derivatives entered into for the purposes of hedging the risks arising in the covered bond program. We would appreciate some elaboration on the calculation method that may be applied when including derivatives as part of additional collateral.

Corporates:

- The BCBS’s high-level summary document² states that “A more granular approach has been developed for unrated exposures to banks and corporates,” however in the more detailed document, it appears that all unrated corporates are still be risk-weighted at 100% and all SMEs at 85% (paragraphs 40 & 43, Table 10). Is there another section or text setting out a more granular approach that has been missed or overlooked?
- For jurisdictions where public credit ratings are disallowed, we expect that the “investment grade” criterion that corporates have securities on a recognized exchange would not apply to certain types of stable entities that do not typically have traded securities, such as pension funds, regulated investment funds (e.g. UCITS and mutual funds), asset managers or other private companies. If the criterion does apply, we assume that the criterion would require diligence similar to that required by listing standards on recognized exchanges – for example, while these investment grade-worthy entities may not have securities on a recognized exchange, they may be subject to (or comply with) listing standards (e.g. audited financials, corporate governance standards). We seek confirmation of our interpretation that since the “investment grade” standard otherwise requires that a bank determine that the corporate entity has “adequate capacity to meet its financial commitments in a timely manner and its ability to do so is assessed to be robust against adverse changes in the economic cycle and business conditions,” the primary rationale for separately including an exchange securities requirement would appear to be conformance with listing standards.

Commercial Real Estate

- Are the definitions and treatments for property valuations for residential real estate (as described in paragraph 62 and referenced above) to also apply for commercial real estate?

² BCBS, *High-level summary of Basel III reforms*, document reference d424hl-summary, page 3.

IIF Specific Requests for Clarification in the Basel III Package, January 19, 2018

Secured Financing Transactions (SFTs): Comprehensive Approach

- We understand that the revised comprehensive risk measure is intended to apply broadly to all secured financing transactions, inclusive of repo-style transactions and eligible margin loans; can this be confirmed?

Secured Financing Transactions (SFTs): Haircut Floors³

- As stock borrow transactions are driven not by an intent to provide financing, but rather an intent to borrow a security, can these transactions be exempted from the framework, provided banks can demonstrate the need for a specific security? It is noted that the current exemption based on how the cash is invested by the lender risks scoping in transactions for which banks cannot charge haircuts.
- We understand that the exemption for regulated counterparties includes broker dealers, and seek confirmation of this. Does this also exempt insurance companies to the extent they are subject to prudential oversight?
- We assume that for a netting set where the bank is a net receiver of cash or a net receiver of government securities, the netting set and individual trades within it are exempted from the haircut minimums?
- How should banks consider netting sets for which transactions pass in isolation, but given the size of different transactions, may fail the floors at the level of the netting set? A Reverse Repo example is shown as follows:

Netting Set				
	Cash	Collateral A	Haircut	Floor
Haircut Floor	0%	6%		
Trade A	1,000	-1,060	6%	
Trade B	-100	107	7%	
Net Trades	Cash	Collateral A	Haircut	Floor
Haircut Floor	0%	6%		
Trade 1	900	-953	5.9%	6%

1.3 Internal Ratings Based Approach

Bank Exposures

- Where the maturity treatment is set out for the FIRB approach (paragraph 107) defining either a set value of 2.5 years (except for repo-style transactions) or allowing measurement of the effective maturity as per AIRB at the discretion of national supervisors, this text (unchanged from the original Basel II paragraph 318) only references “corporate exposures”. We seek confirmation that this paragraph is intended to define effective maturity for ‘bank exposures’ in the FIRB framework also.

Other Financial Institutions

- For the applicability of FIRB treatment (or the revenue-based test for Corporates), are entities such as funds, insurance companies and securities entities to be considered as

³ The industry’s concerns (and several clarifying questions) on the integration of minimum haircut floors for SFTs into the capital framework were previously described in the GFMA letter of January 5, 2016 on “Haircut floors for non-centrally cleared securities financing transactions.” Some of the specific examples outlined in that letter remain valid in light of the new Basel III package, and are highlighted here.

IIF Specific Requests for Clarification in the Basel III Package, January 19, 2018

Corporates, consistent with the definition applied in paragraph 38 of the Standardized Approach section? We note that this differs from their treatment under the Asset Value Correlation multiplier in paragraph 53.

Corporates & Specialized Lending

- One possible interpretation on eligible collateral (where AIRB LGD requirements in paragraph 87 link to FIRB LGD requirements, in turn linked to paragraphs 281 & 296) is that recognition of collateral is prohibited where it is correlated to the borrower, although paragraph 281 also states that this “is not intended to preclude situations where purely macro-economic factors affect both.” We seek confirmation that the intent here is that potential correlations between borrower and collateral are to always be considered, but are not necessarily subject to blanket disqualification.
- More specifically within Specialized Finance, the interaction of paragraphs 74, 83, 86, 87 & 282) have generated considerable confusion on the effective eligibility for modeling LGDs and reflecting the value of assets; we feel this warrants further industry-regulators dialogue to clarify the treatments for this particular asset class.
- With further review of the slotting criteria approach earmarked in the final documents, we would appreciate any elaboration on the intended scope and substance, and also the envisaged timing of this review.⁴

Sovereign Exposures

- While Sovereigns have generally been declared out of scope for the current package of reforms, is it correct to assume that the removal of the 1.06 scaling factor for RWA calculated under IRB (as described on page 2, footnote 3) will apply for all asset classes, including sovereigns?
- Should the updated CCFs for off-balance sheet commitments be applied to sovereign exposures, or should such exposures be unaffected by the new updated CCFs, as EAD is defined for each asset class?

Credit Risk Mitigation

- Where a borrower classified for FIRB treatment is guaranteed by an entity that is classified for AIRB, should the applicable risk-weight treatment move to the guarantor’s status of AIRB? And similarly for an AIRB borrower guaranteed by an FIRB entity?
- With regards to a guarantee (counter-guarantee) or credit derivative in paragraph 192, what does “unconditional” mean? Noting that completely unconditional guarantees may not be a market standard in all jurisdictions, are there any assumed conditions to be exempted?

Estimation Practices

- When using models to estimate CCF or LGD, can default samples of FIRB customers continue to be included in estimation pools for the AIRB approach?

Rating Systems Designs

- On the stability of ratings systems, where the Consultation Document stated that “Migration from one category to another should generally be due to idiosyncratic or industry-specific changes rather than due to business cycles,” we note that this has been changed in the final standard to “Rating systems should be designed in such a way that idiosyncratic or industry-

⁴ The IIF submitted a proposal for a more granular Slotting Criteria, firstly in our comment letter on the IRB Consultation Document in June 2016, and further elaborated for the BCBS Policy Development Group in July 2016. We believe that analysis remains highly relevant, underpinned by data, and maps out a series of more risk-sensitive slots.

IIF Specific Requests for Clarification in the Basel III Package, January 19, 2018

specific changes are a driver of migrations from one category to another, and business cycle effects may also be a driver" (paragraph 182). Is this an intentional change, and a shift in philosophy to direct that ratings should be more variable and sensitive to the business cycle?

2. Operational Risk

Business Indicator (BI)

- Where the business indicator relies on three years of financial statement information, for those jurisdictions that only report audited financial statements annually, is the expectation that banks will only calculate/update the operational risk capital charge once each year?
- For the inclusion of losses and BI items regarding mergers and acquisitions (paragraph 31), there might be a need for further clarity in the scenario where an acquired entity's data may not be available for the entire reference period.

Loss history

- In Section 6 (Specific criteria on loss data identification, collection & treatment), paragraph 25 sets a date "no later than the date of accounting" to be used for including losses related to legal events. In addition, paragraph 26 asks that "linked" losses caused by a common operational risk event that are posted to the accounts over several years, should be allocated to the corresponding years of the loss database in line "with their accounting treatment". To remove ambiguity in the case of legal events that are caused by a common operational risk event, how should such events be assigned within the loss history set?
- With reference to the inclusion of loss events in the data collection and the calculation of average annual losses, should a loss event be included if its first date of accounting (recognition date) occurred prior to the 10-year observation period but it also had one or more impacts within this period? If so, how should the €20,000 threshold be applied?
- Where it is stated that banks may request supervisory approval to exclude certain operational loss events that are no longer relevant to the banking organization's risk profile (paragraph 27), we ask if the conditions for this scenario can be defined in more detail, to help ensure a consistent implementation across jurisdictions and institutions.

Euro conversion

- Should banks use the Euro conversion rate as of the first impact date? Or convert each impact using the rate as of the impact date, and then aggregate them?
- Particularly in emerging markets, the effect of currency conversions to Euro may have a material impact on, amongst others, the calculation of the business indicator component (for example a bank with a business indicator of approximately €1b may fall in bucket 1 for one year and in bucket 2 for another) and the loss component (for example losses of approximately €20,000 may be included for one year but excluded for another). Are banks able to apply a more stable currency conversion (eg. a three-year moving average, as opposed to the spot rate) in order to eliminate volatile capital estimates?

Loss identification Criteria

- We appreciate the distinction made that loss events accounted for in credit risk RWA should not be included in the operational risk loss data set (paragraph 19f). However, we note that a holistic view of all costs in a loss event is also required, specifically including replacement and repair costs (paragraph 23b). In the scenario where a bank has re-purchased a security as a result of an operational risk event, and then holds that security with credit RWA applied, we seek clarification that paragraph 19f is to prevail, to avoid any potential double-counting.

3. Output Floor

We assume that the output floor of 72.5% is indeed applied at the aggregate RWA level as is stated repeatedly throughout the final documents. However, the table which provides an example on how to calculate the output floor has caused some confusion within parts of the industry, particularly where the example could be read that the output floor is binding at the credit asset class and risk type level (paragraph 7).

To verify our understanding that the output floor only applies at the aggregate RWA level, we seek confirmation that our exemplified calculation (tabled below) represents how the output floor would operate if it is binding.

	Pre-floor RWA	Standardized RWA	Output floor (72.5% of total standardized RWAs)
Credit risk	250	475	
- of which Asset Class A	50	100	
- of which Asset Class B	25	100	
- of which Asset Class C	100	125	
- of which Asset Class D	75	150	
Market Risk	5	10	
Operational Risk	20	20	
Total RWA	275	505	366

Securitization

- We seek clarity on the interplay between the external ratings-based approach (SEC-ERBA) and the standardized approach (SEC-SA) for the purposes of the floor, and how these relate with the hierarchy that includes the internal ratings-based approach (SEC-IRBA) as set out in the BCBS *Revisions to the securitisation framework* of July 2016. Will a strict application of this hierarchy apply globally, or can it vary between jurisdictions?