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FRENCH BANKING FEDERATION RESPONSE TO BCBS 2nd CONSULTATION ON REVISIONS TO THE STANDARDISED APPROACH FOR CREDIT RISK

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

I- General comments

The FBF welcomes the opportunity to respond to the Basel Committee's second consultation on revisions to the Standardized Approach (SA) for credit risk. Following our response to the first consultation paper, we look forward to a constructive discussion on how to revise the standardized approach for credit risk and strike the right balance between the need to update the framework, the identification of an approach that is risk sensitive, simple and comparable and the implementation of forthcoming new requirements in practice. Our response develops the following key message:

- The re-introduction of external credit ratings on banks and corporate portfolios should ensure that comparability is maintained between jurisdictions that allow the use of external ratings and those that do not. It would helpful that the Committee promotes a global framework including external ratings agencies supervision in order to reduce reliance on credit rating agencies.
- Specialized lending exposures treatment should be more sensitive to their low risk profile and duly take into consideration the existence of a security package comprising securities, guarantees and covenants, enabling lenders to control the cash flows generated by the asset financed.
- Residential Real Estate exposures treatment should reflect a more risk sensitive approach by allowing , for example, national supervisors to use the LTI (the LTV ratio does not properly reflect the borrower's capacity to repay)
- The notion of Unconditionally Cancellable Commitments should be reviewed and clarified.

- Also, if we welcome the Committee's proposal of an 85% risk weight for SMEs, we fully back a SME risk weight fixed at 75%.

Finally, the standardized approach cannot be completely dissociated from capital floors calibration and ongoing discussions on the Internal Ratings Based approach. We believe that further discussions with the Committee and other relevant stakeholders will be called for in order to define the appropriate regulatory capital treatment across approaches once the results of the QIS and the final proposals will be published. Since the Committee confirmed that the revised methodology may not significantly increase capital requirements, we strongly support the introduction of a grand-fathering clause.

Please find below our detailed answers to the points raised in the consultation paper.

II- Comments on selected portfolios

1. <u>Exposures to banks</u>

We welcome the decision of the Committee to confirm the benefits of using external ratings in calculating the risk weights applied to banks; this is compatible with the reduction of reliance on credit rating agencies as banks use external ratings as part of their due diligences risk assessment.

Nevertheless, the consultation requires external ratings to exclude any indication of government support. Several arguments lead us to think that this constraint on ratings is irrelevant as:

- The progressive implementation of Resolution frameworks across European countries addresses the issue of the existence of government support. In practice, when fully implemented, the BRRD (Bank Recovery and Resolution Directive) will remove any linkage between a bank placed in resolution and its government in the European Union.
- Rating methodologies have evolved in the past years in order to take into account the Resolution frameworks in place in EU countries. For example, S&P has reviewed all its European banks ratings at the end of 2015, in order to exclude potential existing "government support" uplift in its ratings (except in Sweden). S&P ratings now include notches of uplift where national resolution frameworks are well advanced. Earlier in 2015, Moody's also updated its methodology and lowered expectations of the likelihood of government support for banks in light of the introduction of the BRRD in the EU.
- Banks ratings are already effectively capped by the sovereign rating of the country where banks are domiciled.
- Rating agencies in Europe are supervised by the European Securities and Markets Activities (ESMA) since 2012, which amongst other responsibilities, is in charge of assessing the conformity of rating methodologies. Thus, any change required to those would have to be implemented through ESMA at the EU level.

  ⇨ **Proposal to BCBS:**
    - We would recommend that the Committee accepts external ratings as they stand when they are provided by a recognized rating agency, i.e. without excluding government support and promoting a dedicated framework to reduce reliance.
    - The Committee should enforce a common framework without any exemptions.
    - Moreover, the criterion proposed for a classification of banking counterparties into A, B and C buckets within the SCRA methodology needs to be clearly detailed and clarified. Otherwise, there could be a potentially strong comparability issue between jurisdictions using SCRA vs. jurisdictions using ECRA.

2. Exposures to corporates

If we recognize that the reintroduction of external ratings by the Committee is a welcome and appreciated improvement compared to the first consultative document as it contributes to a higher degree of achievement in the 3 objectives set forth by the Committee (Simplicity, Comparability, Risk sensitivity), we think that given the very low coverage of external ratings on corporates (particularly on middle-market firms and SMEs), a large majority of corporate exposures will receive by default a 100% risk weight in jurisdictions that allow the use of external ratings.

Indeed in jurisdictions not allowing the use of external ratings, banks have the ability to assign a risk weight of 75% to all exposures among the "investment grade" category, taking into account that the majority of corporate portfolios are concentrated in the bucket BBB + / BBB / BBB-. In jurisdictions allowing the use of external ratings, the same corporate counterparties will receive a 100% risk weight.

Therefore, there is **a crucial comparability concern in relation to the proposed treatment between jurisdictions where the use of external rating for regulatory purposes is not allowed** (mainly the US) **and jurisdictions using external ratings in their prudential framework** (roughly, the rest of the world).

- ⇨ **Proposal to BCBS:**
  - o Given the limited cases of application of external ratings, we suggest that the Committee applies to unrated corporate exposures the same approach as for unrated banks exposures, i.e. : to apply the "investment grade / non-investment grade" qualification to unrated corporate exposures for banks established in jurisdictions that allow the use of external ratings. In addition, this approach will enable banks to reduce overreliance on external ratings.

Moreover, "investment grade" exposures to corporates (which include both external ratings in the BBB+ / BBB / BBB- bucket and the vast majority of unrated portfolios) are unduly penalized by a 100% risk weight in comparison to the BB+ / BB / BB- bucket, which has the same weighting, thereby giving an incentive to banks to deteriorate the quality of portfolios.

In jurisdictions that don't permit the use of external ratings the proposed approach will allow banks to cover a much larger scope of entities since the qualification of "investment grade" entities will not be limited to corporate entities that are subject to an external ratings –this will lead to reducing the comparability of RWA between jurisdictions**.**

In addition, the definition of "investment grade" in § 173 states, among other criteria, that the entity should have outstanding securities on a recognized exchange. This requirement should be removed since there is no evidence that the existence of listed securities is an objective indicator of the capacity of a corporate to meet its financial commitments.

We believe the QIS exercise will evidence that the two approaches will generate important differences between relevant jurisdictions, thereby materially diverging from the comparability objective.

- ⇨ **Proposal to BCBS:**
  - o Align the risk weight of BBB + / BBB / BBB- and the "investment grade" part of unrated exposures with the risk weight proposed for the corresponding categories in jurisdictions not allowing the use of external ratings, i.e. 75%. This will de facto restore

comparability of corporate exposures prudential treatment between jurisdictions relying on external ratings and those not.

Regarding the due diligence proposal, it does not seem consistent with the simplicity goal, as the Committee is introducing a very high level notion of "due diligence", which will naturally lead to important implementation distortions.

⇨ **Proposal to BCBS:**
- To indicate in the final document that banks using internal approaches could base their due diligence analysis on their internal rating systems assessments, and;
- To give further details regarding the updating of due diligence in case of significant changes on the counterparty of the exposures (rating in particular).

3. <u>Specialized lending exposures to corporates</u>

We appreciate that the Committee has taken into account the propositions provided by banks during the first consultation round. However, the newly proposed treatment, in which specialized lending exposures continue to be unduly penalized compared to unsecured corporate exposures, is in our opinion, still not adequate in its current design.

First of all, we would like to take this opportunity to recall that given their low risk profile in nature, Specialized lending structures (typical in project and object finance) are the most common financing tool in these activities. The use of such specialized lending schemes is key in supporting productive investment, object and infrastructure financing. Some key figures and facts:

- **Aircraft finance**: estimated in 2015 at 122 billion dollars worldwide, out of which 34,1 billion financed by commercial banks, i.e. 28 % (source: Boeing study, December 2015).
- **Rail finance** is at a turning point with an on-going deregulation in Europe and specialized lending also remains a favourite financing scheme in the US. Vast demand for new money exists in both markets to fund the rolling stock, as the ageing fleet must be replaced. Additionally, high sovereign debt limits public budgets for rail investment, as governments are reducing the budget of public operators.
- **Shipping:** the manufacturing of new vessels amounts to an underlying newbuilding market valued in three-digit billions of dollars (about USD 100-125 billion per annum) and the annual sale-and-purchase activity amounts to a notional of one-fifth to one-fourth of such amount.
- **Infrastructure investments** are massive (in 2015: 310 billion dollars worldwide, out of which 278 billion dollars for loans and 76 billion in Europe, source: Project Finance International, 27 January 2015). They therefore require a dedicated prudential treatment maintaining a risk sensitive approach and giving particular consideration to the characteristics of their financing structure.

Generally, Specialized Lending financing benefits from the following characteristics:

- The **control of cash flows** generated by the asset financed, provided by the **structure and security package, which generally comprise security over the assets and/or pledge over the shares of the borrower, assignment of contracts and insurances, etc.… (please see annex 1)**

- **Assets financed relate to large** transportation, social, energy **infrastructures**, natural resources plants, **aircrafts, vessels, railway networks or commodities**, which are **essential for the functioning of the real economy**, and which benefit from **underlying sustainable cash flows (please see annex 1).**

These protective features are reflected in the **low loss rates observed on these SL asset classes**.

Loss rates in Specialized lending financing are significantly lower than corporate exposures:

- **Object:** observation of high recovery rates has shown a low LGD on average (in the range of about 10% for aircraft/ships over a long term period, source *Global Credit Data*): recovery rates are good. **Based on GCD data, to which we conservatively added 5 % (in order to have an equivalent of discounting at loan rate), the expected loss rate is 0.31% for aircraft finance and 0.41 % for shipping.**
- **Projects**: LGD on average, according to statistics produced since late nineties is 23% (source: *Annual Global Project Finance Default and Recovery Study, S&P Capital IQ, December 2015*).
- **Commodity**: Based on Global Credit Data figures, since 2008 average default rate: 0.89%; average loss rate: 0.12%

Observed expected loss rates on these asset classes are low on average:

	Observed Default Frequency (ODF)	**Observed LGD**	**Expected Loss Rate*** (ODF x LGD)
Aircraft finance	1,96%	16%*	0,31%*
Shipping finance	3,13%	13%*	0,41%*
Commodities finance	0,89%	13,30%	0,12%
Project finance	1,50%	23%	0,35%

- *Aircraft, Shipping: source Global Credit Data*
- *Commodities Finance: source AFME Discussion Paper, Capital Treatment of Commodity Finance, December 2015*
- *Project Finance: source S&P (Discounting at loan rate)*

** 5 % conservatively added to the LGD in order to have an equivalent of discounting at loan rate*

NB: GCD data include both senior and junior loans

Specialised Lending expected loss rates are around 0.15-0.40 %, i.e. **much lower than for unsecured corporate loans** (which is estimated to be around 0.81%).

The secured nature of a financing through valuable assets and cash flows has to be taken into account. Current proposed risk weights are unduly conservative and not consistent with those applied to corporate exposure:

- *"Where issue-specific external ratings are not available"*: ratios are unsustainable for European banks which will not be competitive anymore. Indeed, in the Specialized lending category, only very few obligors have a corporate external rating and this figure increases fairly slowly;
- *"For counterparties and/or jurisdictions that allow the use of external ratings":* the Committee suggests to apply to Specialized lending financings "the same risk-weight look-up table that would apply to general corporate debt exposure" which clearly does not give any credit to and ignores the strong inherent mitigants of all specialized lending structures: securities on valuable assets, on tangible cash flows and on ring-fenced structures.

Consequently, we kindly ask the Committee to consider the following:

<u>Regarding Object Finance (aircraft, rail and shipping)</u>:

This category of asset finance is substantially similar to commercial real estate and risk weights should be based mainly on the collateral securing the relevant exposure. Indeed:

- The general comment in paragraph 49 **page 34 of the consultative document** (Real estate exposure class) can apply to object finance exposures where experience demonstrates "sustainably low credit losses associated with the exposures";
- The requirements laid out in paragraph 50 **page 34** can be applied mutatis mutandis to aircraft/rail/shipping financing loans (with relevant drafting); in particular legal enforceability of creditors' claims is effective and valuation of assets is generally appraised independently;
- **Object Finance projects are more standardized and loan repayment schemes follow an amortization schedule versus bullet profiles.**
    - The current proposal does not reflect the low loss rates, of around 0.22-0.41 basis points observed on these asset classes, i.e. more than twice lower than for a corporate unsecured exposure.

⇨ **Proposal to BCBS:**
- Based on observed loss rates for object finance, which are more than twice lower than unsecured corporate exposures ones, we would like to put forward the following matrix for senior positions in Object finance (ref table 11 and 12 page 37 for CRE) :

Table A secured loan with recourse

	LTV <=70 %	70% <LTV <=85%	85% <LTV <=100%	LTV >100%
Risk weight	Min ([40-50%] , RW of counterparty)	Min ([50-75%], RW of counterparty)	Min ([75-85%], RW of counterparty)	Min ([85-100%], RW of counterparty)

Table B secured loan without recourse

	LTV <=70 %	70% <LTV <=85%	85% <LTV <=100%	LTV >100%
Risk weight	[50-60%]	[60-85%]	[85-95%]	[95-100%]

- Using more granular LTV buckets should trigger a progressive risk weight calculation in order to avoid threshold effects.
- Should corporate exposure risk weights be reduced from 100% to 75%, then the above mentioned matrix should be automatically adjusted downwards accordingly**.**

<u>Regarding Project finance:</u>

- While corporate financing has a short to medium time horizon, infrastructure financing, thanks to the long asset life and their strategic nature for economic growth, is considered over the long term.
- Risk analysis relies therefore on a dedicated contractual structure of commercial agreements, cash flow projections and assets value as appropriate. Considering the protective nature of the contractual structure, **distinguishing pre and operational phase in terms of risks analysis does not make sense for project finance.**

- ⇨ **Proposal to BCBS:**
  - To examine more closely the underlying business and risk profile of this Specialized lending strategic activity in view of developing a more appropriate capital treatment than the corporate framework, taking into account the following features:
    - Lenders benefit from **securities over the assets** and contracts and from a **strict control over the cash flows of the borrowers** (cash waterfalls, limitation on investments and further indebtedness, limitation on dividend distributions, etc.);
    - **Default and recovery long term statistics collected over more than 15 years provide evidence that default and recovery rates are better in this Specialized lending activity than those of corporate exposures.** Based on the average observed default and recovery rates in Project finance over the last 15 years (default rate of 1.5% and recovery rate of 76.6%) compared with average Corporate default rates (1.8%) and LGD retained for this asset class (45%), the respective Risk Weight are:
      - for an identical 2.5 years loan maturity, a 58% risk weight for Project finance exposure against a 118% risk weight for Corporate;
      - for a 2.5 years corporate loan maturity versus a 5 years Project finance loan maturity, a 75% risk weight for the Project finance exposure against the same 118% risk weight for Corporate.

  These 60/42 points differences of risk weight between those two asset classes must be reflected in the regulatory capital requirement through a discount (51% to 36%) to corporate treatment.

  - Alternatively, to adopt a simplified slotting methodology on Project finance exposures based on a couple of basic criteria among which:
    - Long term offtake contracts (including fixed prices and volumes),
    - Ratios (LLCR, Loan Life Cover Ratio (Discounted sum of future project cash flows/Loan amount) and residual asset life after loan maturity),
    - Construction risk (taking into account mitigating elements /securities),
    - Country risk; (taking into account mitigating elements/covers),
    - Parent (Sponsors) quality, and
    - Seniority.

  This would preserve the risk sensitive framework needed to allow the adequate capital treatment of Project finance exposures.

<u>**Regarding Commodity Finance:**</u>

Commodity Finance lending is at the forefront of the real economy where banks facilitate physical commodity supply chains that fuel industry, feed manufacturing and nourish populations. Imposing measures which penalize this form of Specialized Lending may result in a withdrawal of liquidity from the many borrowers whose performance ability relies on this form of finance.

A flat risk weight of 120% proposed by the Committee, for Commodity Finance in particular - is **clearly much higher than implied RWAs based on aggregated historical data collected among banks active in Commodity Finance.** Based on these historical figures, implied LGD has consistently been below 20% over the years, which is much lower than generally observed Corporate LGDs, leading to implied RWAs of 33% with 1 year maturity, or lower than 50% with 2.5 years maturity (source AFME Discussion Paper, Capital Treatment of Commodity Finance, December 2015, based on data gathered by GCD).

Structures developed around Commodity Finance mean that this is typically **a secured activity with collateral that can easily be turned into cash.** Moreover, firms have invested in dedicated transaction management teams in order to manage their underlying transactional portfolios more effectively. It is testament to such infrastructure that during the most recent global crisis of 2008-10, Commodity Finance default rates have not appeared to increase.

The Standardized Approach is borrower specific and does not take into account the structure, collateral and other security types. No recognition is given in the current proposals for the short-term, uncommitted and trade-related nature of Commodity Finance exposures. Trade financings are mostly self-liquidating in nature and truly short-term, i.e. 30 to 90 days. In addition, deals are typically secured by very good quality collateral, such as commodities for which liquid terminal markets exist, or Receivables.

- ⇨ **Proposal to BCBS:**
  - o To introduce specific, lower risk weights by this subcategory within SL, taking into account structure/collateral specific elements. For this asset class, the Global Credit Data has gathered historical database from 8 banks[1] active in this sector that we consider representative for fair analytics. Hence, we would like to suggest building a RWA dedicated grid based upon implied risk weight values ([33 – 50 %]).

As a general conclusion on Specialized lending category:

The Basel 2 framework has contributed to a better risk sensitive capital framework. Preserving the IRB risk sensitive approach is fundamental to meet the challenges of infrastructure and object financing and answer efficiently to market demands. Only risk sensitive approaches are able to select the most suitable lending activities, contributing to the stability of the banking sector. Moreover, a flat risk weight irrespective of the structure, coupled with an LTV, may lead banks to grant loans to riskier structures/obligors as there would not be any capital incentive to further secure the transaction.

A significant rise in Specialized lending weightings would force banks to allocate much more capital against those exposures, which could only be achieved through a combination of massive rises in pricing conditions, degradation of loan parameters (e.g. lower advance rates, shorter tenors), which in the view of customer financing needs would probably appear unbearable. This process may ultimately lead to a large reduction in the volume of funds allocated to those activities with a detrimental effect on the global economy.

The impact on commercial banks would have a damaging effect on the development and renewal of critical infrastructures assets.

Our members therefore kindly ask the Committee to consider the proposals herein and review the calibration of RWAs in order to reflect the low risk of the SL asset classes.

It is worth noting that the banking industry proposals still overestimate risks of the portfolios of main banks active on these activities and thus penalize them, resulting in important negative impacts on the real economy. Banks are therefore available to work further with the Committee on the definition of a floor that could be based on harmonized IRBA models, which best reflect Specialised Lending risks.

[1] Rabobank, ABN-Amro, ING, Citi, Société Générale, BNP-Paribas, Crédit Agricole and Commonwealth Bank of Australia.

4. Real estate exposure class

4.1 Residential real estate

It is widely recognized that there are different credit policies for home loans: the two main ones are distinguished by their diametrically opposed characteristics: one is "Loan-to-value / variable rate[2]" model (e.g. UK, US) and the other the "Loan-to-Income / fixed rate" model (e.g. France, Japan).

The "Loan-to-Income / fixed rate" model relies on 3 principles:

- The loan has a fixed rate: the customer has no surprise on the amounts to repay, monthly payments are predetermined taking into account the amortization of the loan. He does not suffer from exposure/risk to market fluctuations. Any increase in rates does not affect him and a rate decrease even generally make him enjoy additional income resulting from the renegotiation of the loan rate or the repayment thereof at almost no or a low penalty. The customer is even more creditworthy as its purchasing power increases. In this business model, the customer has the choice to prefer a floating rate credit with cap and / or floor, but this alternative is rarely used, directing the customer's choice wisely to fixed rates: in 2014, fixed rate loans represented 92% of new home loans in France[3]. Meanwhile, banks have developed a very sophisticated ALM to monitor risks involved.
- The decision is made by the bank based on the ability of the client to repay the loan. The granting of credit occurs only if the client has sufficient income: in principle repayment of the loan cannot exceed 30% of his or her income calculated after tax. The focus is primarily on the client's capacity to repay the loan and not on the value of the house or apartment taken as collateral (LGD). This is in line with the classic case of prudential risk analysis based on the probability of default of the borrower.
- The loan-to-value, i.e. the value of the house or apartment, only comes to define the value of the cash portion of the loan that must be paid at the time of the loan acceptance.

Thank to these characteristics and the obligations to subscribe compulsory death and disability insurances, this model generates very low default rates. As an illustration, the gross non-performing loan (NPL) ratio for housing loans in France was between 0.89% and 1.45% from 2001 to 2013[4].

LTI shows 3 comparatives advantages: simple (to compute and to analyse), easy to compare, and risk sensitive, particularly to the risk of non-repayment (main risk in the RRE portfolio). In addition the LTI indicator is generally understood by customers.

The calibration based on the ongoing QIS will be achieved on the basis of the Loan-to-Value model, with customers having a higher risk profile: it will, at least partially, undergo an increase in interest rates that is very likely to happen within the next 15 years. This will result in risk weighted assets calibration totally disconnected from the approach adopted in "Loan-to-Income / fixed rate" banks.

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[2] The dramatic impact of moving to a Loan-to-value / variable rate model has been highlighted in a 29/02/2016 joint press release by France's real estate industry professionals representatives (LCA-FFB, Les Constructeurs et Aménageurs de la Fédération Française du Bâtiment, FNAIM, Fédération Nationale de l'Immobilier, FPI Fédération des Promoteurs Immobiliers) http://www.fnaim.fr/actualite/556/3633-les-nouvelles-normes-prudentielles-pourraient-elles-penaliser-la-distribution-de-credits-immobiliers-aux-particuliers-.htm.

[3] « The housing finance in 2014 » (ACPR).

[4] « The housing finance in 2014 » (ACPR).

The increases in risk weights will negatively impact not only newly granted but also formerly approved exposures. An adequate phase-out period should be contemplated on the basis that the impact on current borrowers and banks should be given enough time to adapt their lending conditions to the new rules. We therefore strongly support the introduction of a grand-fathering clause.

⇨ **Proposal to BCBS:**

- The calibration of risk weights should be based on LTI, risk weights should reflect the lower risk nature of fixed rate loans, and thus possibly include the loan rate type as a risk driver in the RWA tables. Therefore the risk weight for a fixed rate loan should be 20% lower than a variable rate loan. Such approach is similar to the add-on approach for the risk weight of a loan whose currency is different from the revenue of the client.
- Alternatively, either the jurisdiction / the country recognizes the concept of LTV as the best key risk indicator or the jurisdiction does not recognize it. In this latter case, the Committee could authorize the use of the Loan-to-Income ratio or any similar indicator (Debt Service Coverage Ratio, etc.). The national competent authority would have to lay down strict and predefined valuation criteria. On this basis, an appropriate risk weight that reflects the credit quality of the counterparty would be assigned to the total exposure. The following table illustrates how this approach could work in practice:

Low LTI	Mean LTI	High LTI	Very High LTI
[20-30]%	[30-40]%	[40-60]%	RW_counterparty

Finally it should be noted that the LTV model has major weaknesses:

- It creates cliff effects around LTV thresholds.
- It significantly increases risk weights for exposures which LTV is above 80% i.e. for most of the market and certainly for first time buyers.
- It encourages regulatory arbitrage amongst banks: exposures could be split so that each bank minimizes its LTV and optimizes RWAs.

4.2 Buy-to-let portfolio

There is a significant increase in risk weights for the "buy-to-let" portfolio that was formerly called Income Producing Real Estate (IPRE) while, in many countries, these exposures are not riskier than the rest of the residential portfolio[5].

4.3 Commercial real estate

Should the RW applied to unrated corporate exposures be reduced, the RW matrix should be automatically adjusted downwards accordingly.

[5] « The housing finance in 2014 » (ACPR).

4.4 Land acquisition development and construction

The ADC loan risk weight treatment (150%) proposed by the BCBS[6] is determined by the fact that the "*source of repayment at origination of the exposure is either the future uncertain sale of the property or cash flows whose source of repayment is substantially uncertain*".

After demonstrating that in France the future sale of property or future cash-flows to allow repayment of the loan are NOT substantially uncertain, we propose that the Committee should give a 100 % risk weight to those development loans which are eligible according to the criteria set out below.

Our proposal is based on minimum thresholds (signed sales or pre-leases) to be reached, the level of such thresholds depending on the asset type (residential or commercial).

Residential development finance

The French residential development financing scheme, which is a common market practice shared by all banks active in France, relies on two key protective elements (both legal and financial):

- The immediate transfer of the legal ownership from the developer to the purchaser(s) through signed notarial acts, even though the building is not completed, and the presence of a bank completion guarantee. Such practice protects all parties (developers, bankers and final buyers). This immediate transfer of legal ownership is executed under the legal mechanism of VEFA (*Vente en Etat Futur d'Achèvement,* defined since 1967 by French law). All sales in France of residential property under development are by law secured by the VEFA mechanism and by its associated financial completion guarantee (GFA – *Garantie Financière d'Achèvement*). [7]
- The presence of signed notarised VEFA sales as condition precedent. Such signed notarised VEFA sales are one of the key elements to secure the transaction (together with the equity and the developer's margin), to validate the "adequacy" of the asset within its market and to demonstrate the likelihood of the future sales coming from the residual stock and their future related cash flows.

These legal and financial protections have demonstrated their efficiency during the past years, with very low historical default rates observed in such activity.

- ***As long as signed notarised VEFA sales represent a minimum of 30% of the expected total sale revenues of the residential development programme, we propose that a 100% risk weight is applied to the loans financing this programme.***

Non-residential development finance

Banks are also major partners for the development finance of commercial projects (offices, retail, logistics and hotels).

This lending is often secured by signed notarised sales to investors under the VEFA mechanism, which is a key element to secure the future cash-flows, while relying on a more volatile asset risk profile than residential development finance.

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[6] BCBS Second Consultative Document (d347) dated 10 December 2015: paragraph 1.5.3 (page 14), and Annex 1, section 9.3, paragraph 61 (page 37).
[7] We understand that similar legal schemes exist for instance in Luxembourg.

Commercial development lending can also be secured by pre-leases (BEFA – *Baux en état futur d'achèvement*) which secure as well the future cash-flows deriving from the asset(s) at completion.

⇨ **Proposal to BCBS:**

- To be consistent with the risk-sensitive approach for ADC loans (which depends both on the asset type – residential or not residential - and on the level of legal "strength" of the condition precedent – signed notarized sales or pre-leases), we propose the following:
  - If the asset is sold (through VEFA) for an amount representing 100% of the expected total sale revenues from the asset being developed, we propose that a 100 % risk weight is applied to the loan financing this development;
  - If the asset is pre-leased (leases signed concerning a defined property under construction for occupation on a defined date on the basis of an agreed base rent) for an amount representing 70% of the expected total lease revenues deriving from the asset at completion (thus giving a high probability for the asset to be sold at completion), we also propose that a 100 % risk weight is applied to the loan;
  - Finally, if the LTV at completion is less or equal to 80% (which is consistent with the approach summarized in table 12 page 37 of the Consultative Document) AND either signed notarized sales or pre-leases represent a substantial proportion of the total expected sales or lease revenues respectively of the completed asset, we also propose that a 100 % risk weight is applied to the loan.

In France, as in most economies, real estate is a key economic sector with broad impact throughout the economy, in particular on employment and competitiveness. A regular and significant flow of modern buildings, both residential and commercial, helps both the household and the corporate sectors to adapt to rapidly changing economic and demographic circumstances. Development finance is thus vital to maintain this major contribution to the health of the French economy.

For this reason, penalizing loans fulfilling the above described conditions (legal and financial protection), by increasing the cost of development finance, could jeopardize the financial equilibrium of an entire strategic economic sector. This in turn could lead to both a credit crunch and a significant rise of real estate prices and rents, making property increasingly unaffordable for both borrowers and tenants. The French economy will suffer as a result.

- We propose therefore the following formulation for § 61:

  "61. Land acquisition, development and construction (ADC) lending will be risk-weighted at 150%. ADC includes loans to companies or SPVs financing any of the land acquisition, development and construction of any residential or commercial properties where the source of repayment at origination of the exposure is either the future uncertain sale of the property or cash flows whose source of repayment is substantially uncertain. ADC exposures will also include loans to companies or individuals to finance the acquisition of finished property where the repayment of the loan depends on the future uncertain sale of the property.

  The repayment of the loan is deemed to be sufficiently secured by both the immediate certain sale of a significant proportion of the property to be developed or by the signature of pre-leases as condition precedent in the following cases:

Residential / Signed notarised sales	***Non-Residential / Signed Notarised Sales***	***Non-Residential / Pre-leases***	***Non-Residential / Other cases***
30% of the expected total sales revenues	*100% of the expected total sales revenues*	*70% of the expected total lease revenues*	*LTV <= 80% and a substantial amount of notarised sales or pre-leases have been signed*

In such cases, the loan will be subject to a risk weight of 100%."

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

The Committee's proposal extends the currency mismatch add-on– which was initially scheduled for retail activities only – to all type of exposures, including large corporates. The potential impact of such a +50% add-on is very strong, and is not adapted to the corporate asset class.

Indeed, whereas the implementation can be easy (and make sense) for retail exposures, it could be very complex for large companies, considering that the current wording suggests that main source of income analysis must be carried out and stored in systems for all counterparties.

Moreover, this proposal could be a strong obstacle to the development of international SMEs (in need of foreign currency resources to establish themselves in a new country).

Through the consultative document, the Committee intends to extend the application of the risk weight add-on to the corporate portfolio. Specifically, banks would apply a 50% risk weight add-on to "unhedged exposures" with currency mismatch, where "unhedged exposure" is defined as an exposure to a borrower that has no natural or financial hedge against foreign exchange risk arising from the currency mismatch.

We believe requiring an add-on in this regard is not appropriate due to that fact that such credit risk is already factored in as part of due diligence requirements and of the external rating as well as in the Investment Grade qualification, outlined in the corporate portfolio section of the consultation, and therefore will lead to double counting of such risk.

A burdensome and complex exercise in practice

As currently proposed, banks will have to check and keep a detailed audit trail for each facility to ensure that there is no currency mismatch, which will entail highly burdensome level of due diligence that could be untenable for certain SME portfolios. In addition, the proposal does not introduce any proportionality. For example, if a corporate has its main revenues, but not all, in a given currency (for instance USD), it means that any loan in a different currency, irrespective of the amount, will be subject to additional risk weight.

- Take for example the corporate EXXON (AAA rated), whose main revenues ($394Bn) are in USD: a $100M loan to this company in a different currency will induce an additional Risk Weight of 50% and ultimately a RW of 75%. Is this loan more risky than any other USD exposure to this company? We believe not.

Paragraph 63 of the consultative paper states that a "financial hedge against the foreign exchange risk resulting from the currency mismatch between the currency of the loan and the currency applied to pay down the loan would constitute a natural hedge". From an operational point of view this statement may be hardly feasible since it means that corporate customers should provide such private information to the borrower –very unlikely given the information that such a contract may contain (price information for instance).

<u>The add-on for currency mismatch is not appropriate</u>

A loan in USD to a counterparty which main revenues are in Euros will be subject to an additional risk weight, whereas a loan in Euros to the same counterparty that makes a cross currency swap EUR/USD will have no additional RW while the risk of default is the same for the lender.

A Corporate customer can have many other FX exposures under other means than loans in a different currency: for instance a corporate with expenses in € and revenues in USD (and vice-versa). This is the case for aircraft manufacturers or Airways companies, non-US commodity companies, etc.… as stated above, this assessment should be part of the due diligence process.

Such additional requirements will induce an increase in the financing cost for middle market corporates wishing to borrow foreign currency to develop their activity in new foreign markets where they do not yet have existing revenues:

- Let's assume that a middle market retail company wants to open a subsidiary in a new country. For this development they need to rent offices, shops and commercial facilities, and to buy equipment locally. Thus they need local currency resources to cover these expenses, which will be repaid by the revenues generated locally; the company will need to borrow in local currency but since its main currency of borrowing is not the local currency in our example, the lending bank will apply a 50% add-on on this loan which will be reflected in its final pricing. This add-on will be an obstacle to the international development for middle market companies. Worse: it will push these companies to borrow in their national currency and thus create a currency mismatch between their revenues (in local currency) and their debt.

<u>Overall, this proposal will increase the complexity of the framework while its benefits are unclear</u>

The add-on could also have a sizeable negative impact on emerging economies corporate clients. We believe that the proposal should take into account the fact that companies from dollarized economies, such as those in Latin America, can transfer this currency risk to their customers and suppliers.

⇨ **Proposal to BCBS:**
  - To clarify the scope of application of the currency mismatch add-on, and reduce it to retail exposures, as it was the case in the first consultative document, i.e.:
    - Maintain the add-on for retail and residential mortgage exposures;
    - Suppress the application of this add-on to corporates as, by nature, they have many means to cover their currency risk, and because their incorporation in the framework would be too complex and useless in term of risk measurement.
  - To delete the reference to "main source of income" in § 62 Appendix 1 in order to align with the core text proposal.

6. Off-balance sheet exposures

The concept of UCC (Unconditionally Cancellable Commitment) is old dated (introduced in 1988, it has never been reviewed since that time) and unclear. Indeed, the application of a CCF higher than 0% for UCCs raises many questions since the concept of commitment that can be cancellable at any time without conditions is somehow contradictory: if a bank can cancel the so-called commitment, in practice the banks is not committed. **Thus the Committee should not consider that this UCC is a commitment**.

The new Standard proposal introduces uncertainty regarding the prudential treatment of unconditionally cancellable commitments, which will switch from a 0% CCF today to a [50%; 75%] in the future framework.

Some uncertainties exist around the following issues:

i) Scope of application

The Unconditionally Cancellable Concept could cover many realities:

- Commitment revocable to the full extent allowable under consumer protection and related legislation
- Commitment automatically revocable in case of deterioration of the borrower's creditworthiness
- Written document given to the client where the banks open a credit line and states that it can cancel its commitment to lend at any time without prior notice and without conditions
- Oral commitment to the customer, stating that the bank can cancel it at any time
- Past overdraft, authorized by the bank, without any written document sent to the client (i.e. : the bank has granted an authorization to draw but can refuse at any time any new drawing, but no contract exist)
- Credit limit decided by the credit committee, orally communicated to the client or not
- Counterparty risk limit
- Market risk limit

Thus we urge the Committee to review the definition and concept of Unconditionally Cancellable Commitment and to clarify the boundary between commitments and other situations that should not attract any capital charge, in particular to confirm that the alignment between accounting and risk has to be fulfilled in regard to UCCs.

ii) Alignment with accounting

In some jurisdictions these situations (the so-called UCC commitments) are not reported in financial accounting:

- This is the case under IFRS norms (please see annex 2)
- The current framework is based on an alignment of risks exposures on accounting figures
- This was not an issue due to the absence of capital charge thanks to the 0% CCF

We think that the Committee should confirm that accounting reporting should remain the unique reference for the calculation of RWA and not open any room for a divergence between the accounting reference and the risk perimeter.

Comments with respect to the proposed [50 – 75%] CCF level:

In our view, CCF applied on the "true" UCC has to be significantly lower than CCF applied to committed facilities, for the following reasons:

- Corporate clients are happy with UCC because they don't pay for it (banks and their clients don't consider it as a service). As a consequence corporate client are fully aware of the revocable characteristics of the UCC. On the contrary when the corporate needs a firm commitment (for instance in order to fix the cost of financing or because it will improve its external rating or to fix the operating conditions of a commercial project) he is ready to pay for it. Thus both parties are fully aware that they are not committed and corporate clients accept this risk.
- On the bank's side, as there is no contractual commitment toward the client, the situation may (and will) be re-assessed prior to the drawing by the client depending on the set-up.

As far as the bank has the capacity and the right to cancel its commitment, the Committee should consider that if the bank agrees any drawing or utilization by its customer this is a management decision due to a new situation rather than the consequence of a supposed obligation of the existence of a UCC: there should not be a direct link between the UCC and any utilization of a line.

Otherwise, assigning a capital charge to the UCC would be equivalent to assigning a capital charge on a future exposure (for instance a future new loan to a future new customer), i.e.:

- If a bank wants to develop its credit activity on a new market and knows that it will have future credit exposures on this market
- An internal market risk limit that is not used
- A credit committee decision to authorize an envelope for a client, a country, etc. …
- The prospection for the creation of a commercial relation with a client with an internal limit to start the discussions with the client.

Reputational risk consideration has no link with UCCs

The Committee in its consultation paper mentions reputational risk as a factor that could force a bank to execute an UCC, but the reputational risk is not to be covered by the standard approach for credit risk (this is by the way currently addressed through the Committee's step-in risk consultation).

⇨ **Proposal to BCBS:**
  - To clarify the definition of UCCs we should distinguish between these two main types of banking arrangements to corporate clients:

    1) Risk limits: Legally Non-Binding i.e. at any moment in time, Lenders can accept or decline the request for drawing (loans) or the issuance of an off balance sheet commitment (Letters of Credit, guarantees, etc.). As such, it is not a commitment by Lenders to make loans or to issue LCs and no commitment fee is being paid. These risk limits can be documented through an Agreement signed by both parties (Master Agreement or Bilateral Agreements) typically under English/New-York laws. This type of agreement granted by the Lender shall not bear any capital requirement since it is fully uncommitted by nature. Hence, CCF do not apply and the bank has no accounting of an off balance sheet commitment but only an internal authorization granted to the client.

2) Unconditionally Cancellable Commitments: These commitments can be cancelled at any time or with a notice period and should be treated on a case by case basis according to Governing Laws to determine the level of actual "commitment" from the Lenders in various jurisdictions (frozen lines, repayable period).

- We believe the CCF on these Unconditionally Cancellable Commitments cannot be at the same level as a committed facility since the Lenders can indeed suspend drawings at any time to their sole discretion whereas the unused portion of a committed facility can be drawn by the Borrower up until maturity (except in case of eventual breach of covenants, if any).
- In particular "commitments" that can be cancelled by the bank at any time without prior notice, without conditions should be subject to a 0% CCF (or excluded from the prudential perimeter) since these are not commitments by definition.
- In any case, UCC subject to conditions or not (consumer protection law, cancellable in case of credit deterioration) should attract a 0% CCF as far as the client cannot draw the commitment without an action from the bank.
- Other Commitment subject to conditions (consumer protection law, cancellable in case of credit deterioration) currently receiving a 0% CCF would be subject to RWA calculation (higher than 0%).

The new Standard proposal introduces uncertainty about the treatment of unused confirmed credit lines, receiving today a 50% CCF, and potentially subject to the range [50%; 75].

⇨ **Proposal to BCBS:**
- To maintain 50% of the undrawn part of confirmed lines in accordance with the current framework and with proposed treatment under the leverage ratio framework.

III- Annexes

Annex 1: definitions of object, project and commodity finance

Object Finance:

Generally, object finance loans are secured by liquid and valuable assets, which generate cash flows over the long term. Aircrafts financed are wide body, narrow body and regional aircrafts. The Object Finance loans don't include private jet aircraft financing. Vessels financed in the Shipping SL category comprise dry-bulk, tankers – crude/product/chemicals, container boxes carriers, LNG/LPG gas carriers, offshore services, cruise vessels, but don't include pleasure ships bought by individuals.

The structure of the financing enables lenders to control the asset and the cash flows generated, generally through an isolation of the loan and the asset financed in an SPC (Special Purpose Company), and/or a direct security in the asset, and the assignment of the lease contract or of the time-charter contract or earnings, and of insurances.

Lenders benefit from several layers/cushions: conservative Loan to Values, and loan terms typically much shorter than the asset life, which enables to postpone the maturity if needed.

Project Finance:

Project Finance loans are secured by valuable cash flows/asset values. They consist in the financing of large long-term infrastructure assets generating sustainable cash flows over the long term.

Assets financed comprise transportation and social infrastructures assets healthcare infrastructures (hospitals), public infrastructures (schools, ministries, police headquarters) and military infrastructures), environmental infrastructures (waste treatment plants, water treatment and desalination plants), natural resources (LNG, Pipeline and storage, oil and gas offshore infrastructures, petrochemicals, refineries, metals plants), telecommunication infrastructures (cable, towers, satellite), power infrastructures (electricity generation (renewable, such as Wind Farms, Solar plants, Biomass Power Plants and conventional power plants (such as gas fired power plants)), transmission / distribution of electricity). Those assets are generally operated in regulated markets.

The structure and security package enable lenders to control cash flows generated by the asset financed with a security over the asset and/or a pledge over the shares of the borrower, the assignment of contracts (notably off-take and supply contracts) and insurances, and limitations of additional indebtedness, limitations of new investments, of distribution.

Lenders benefit from two layers of cushion: a cover of debt service by cash flows above 1, until maturity which enables the borrower to bear periods of lower cash flows. The second layer of cushion lies in the residual asset life after loan maturity, as loans tenors are generally shorter than asset lives, which enables to postpone maturity if needed.

Commodity Finance:

Commodity Finance covers the financing of the physical supply chains to three primary commodities sectors, namely, “Energy” (Oil & Gas and others), “Metals” (and Minerals), and “Agricultural Products” (Softs and others). It does not include the financing of manufactured products trade.

Commodity Finance relates to short term self-liquidating facilities, (i.e. that can well proceed independently of the borrower) and benefit from securities on the commodities financed and on receivables.

Annex 2: accounting treatment of commitments

The term “commitment” is not defined in the IFRS universe (contrary to terms such as “firm commitment” or “firm purchase commitment”).

Some IFRS standards (such as IFRS 12 Disclosure of Interests in Other Entities, IAS 17 Leases, and IAS 24 Related Party Disclosures) provide some detail on the notion of “commitment” to which their disclosure objective relates, even if they do not define precisely that term.

However, with respect to liabilities, The Conceptual Framework for Financial Reporting issued by the International Accounting Standards Board (IASB) notes that “a decision by management to acquire assets in the future does not, of itself, give rise to a present obligation unless the entity enters into an irrevocable agreement to acquire the asset”.

Given that commitments are undefined in the literature, it might appear from the text mentioned above that irrevocability is a key differentiating feature, even for disclosure purposes.

This is the interpretation made by EU banks (applying IFRS for their financial statements at consolidated level when they are listed on an active market).

The global practice among EU banks is to consider that commitments shall be booked in the disclosure notes as soon as (cumulative requirements):

- they are deemed as irrevocable,
- it becomes likely (i.e. more likely than unlikely) that resources (cash flow) must be put up to fulfil the lender’s obligation,
- this cash outflow is estimated in a reliable manner.

A commitment is irrevocable if it cannot be cancelled or modified without the consent of the parties involved, even if, in certain cases, its implementation is conditional and subordinated to the occurrence of a future and uncertain event, or can be cancelled out via an advance notice.

A distinction shall be made between:

- Conditional commitments that do not allow the bank to revoke its commitment unilaterally: the institution makes the commitment in writing, but can revoke its commitment without penalty if certain 'covenants' or conditional clauses are satisfied (for example, in case of a worsening of the client rating or the economic situation of the country). These terms do not jeopardize the irrevocable nature of the commitment into question given that the commitment is not revocable by the lending institution alone, but due to the occurrence of a future and uncertain event.
- Conditional commitments in which the bank can retract from its commitment unilaterally: unlike the previous point, certain written agreements may contain conditional clauses that allow the bank to revoke its commitment (in good faith) unilaterally. For example, underwriting commitments issued by the bank include suspensive conditions relative to the writing of the documentation do not need to be recorded in OBS.
- Commitments with advance notice: the institution makes a commitment in writing, but can revoke its commitment without penalty if advance notice is given as defined contractually. However, until the advance notice has elapsed, the commitment remains irrevocable.