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## Consultation response

### **EBA Draft RTS on Assigning Risk Weights to Specialised Lending Exposures**

11 August 2015

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The Association for Financial Markets in Europe (AFME) welcomes the opportunity to provide our preliminary feedback on the **EBA's Consultation Paper on its Draft Regulatory Technical Standards on Assigning Risk Weights to Specialised Lending Exposures under Article 153(9) of the CRR**.

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Transparency Register, registration number 65110063986-76.

### General comments

In light of the emphasis of EU policy making on achieving long-term, sustainable growth, AFME wishes to stress the importance of specialised lending products receiving appropriate consideration in the regulatory capital framework. Risk-sensitive capital requirements that recognise the low risk nature of many specialised lending exposures are paramount, particularly as these products enable the financing of real assets including significant infrastructure projects. Capital requirements that fail to reflect actual risk levels are likely to make the provision of these products uneconomic, with negative consequences for end-users and economic growth in the EU.

While we understand that the present consultation is limited in scope to the functioning of the slotting approach for specialised lending, an approach that is used to assign risk weights for a relatively limited portion of these exposures, we encourage the EBA to give careful consideration to the treatment of this exposure category in the context of other relevant ongoing workstreams. These include the work of both the EBA and the Basel Committee on the future IRB approach, as well as the revision of the Standardised Approach for Credit Risk where the Basel Committee's proposal for specialised lending exposures do not appropriately reflect the underlying risk profile of these assets.

Before answering the individual questions raised in the consultation, AFME wishes to stress that, currently, the main source of inconsistency with respect to the treatment of specialised lending exposures under the IRB approach is due to divergences in supervisory practices between competent authorities. Today, supervisors in a limited number of jurisdictions impose slotting as the default approach for calculating capital. This results in different capital requirements for different firms active in the same markets.

Again, while we appreciate that this particular consultation relates to the mandate given to the EBA in Article 153(9) of the CRR, given that the objective of achieving converged supervision throughout the EU is at the core of the EBA's mission, we strongly recommend that the EBA seeks to resolve the above supervisory inconsistency as a matter of priority and before considering the costs and benefits of making changes to the mechanics of the slotting approach itself.

Consistent supervisory practice in terms of which approach firms are allowed to use to calculate their regulatory capital requirements is also fundamental in achieving a level playing field throughout the EU. Recent EBA work on the SREP and IRB Assessment Methodologies should contribute to reducing supervisory divergences as they are incorporated into supervisory process and are very much welcomed. Nevertheless, industry considers that the slotting approach for SLEs provides a good opportunity for the EBA to resolve a specific, concrete area of divergence within EU supervisory practice within the short term. We encourage the EBA to address this issue with its members before considering introducing additional change to firms' current practice.

We also wish to point out that there should be consistency between the capital outcomes for specialised lending exposures across the various approaches in the CRR framework (i.e. when comparing the requirements under the Standardised Approach, the slotting approach and the other IRB approaches). Currently, for the same exposure, the slotting approach can give rise to higher risk weights than under the Standardised Approach.

Lastly, with respect to the slotting approach itself, AFME appreciates the challenge inherent in arriving at the appropriate combination of criteria that are sufficiently precise to lead to comparable outcomes between institutions with comparable exposures, while at the same time ensuring the criteria are flexible enough to cover the wide range of product features, available risk mitigants, local definitions and legal environments that characterise the specialised lending space.

In our view, if the EBA can specify an approach to combining the various factors into a final assessment that achieves this balance, and where the relevant competent authorities ensure it is consistently applied throughout the EU, this RTS will contribute to ensuring comparability across institutions using the slotting approach.

## Responses to consultation questions

**Question 1:** *What are the operational challenges of using the slotting approach? Is it possible to obtain comparable capital requirements across institutions using the slotting approach? Should the slotting approach in your view be extended to other types of exposures, and if yes, for which types of exposures would this be particularly useful?*

In order for capital requirements to be consistent across institutions using the slotting approach, it is essential that supervisory practice also be consistent. In AFME's view, the EBA should therefore consider how to converge supervisory practices in relation to slotting as a matter of priority amongst its members.

AFME cautions against extending the slotting approach to other types of exposures under the IRB Approach. While potentially useful in the specific case of specialised lending exposures where IRB firms are not able to estimate PDs or where their PD estimates do not meet the relevant requirements for PD estimation, slotting is a less risk sensitive approach to determining capital requirements than requirements based on measurements of the actual underlying risk of an exposure. The levels of capital a bank is required to hold under a slotting approach may therefore not be precisely reflective of its true risk levels, whereas the objective of the IRB Approach is to ensure that capital levels are fully commensurate with risk levels.

Without risk sensitivity, or indeed with less risk sensitivity, the capital framework is likely to misrepresent a firm's true risk levels and may incentivise misguided origination. The less risk sensitive the framework is, the more opportunities for regulatory arbitrage are created, incentivising firms to seek higher risk assets as a means of boosting expected returns. A lack of risk sensitivity can also lead to the inappropriate pricing of risk, less lending in low-risk asset classes, less diversification across firms' portfolios and a corresponding increase in risk to the financial system as a whole. Importantly in the current EU policy context of needing to promote growth and develop a Capital Markets Union, risk sensitivity in the framework is needed to avoid certain products, such as specialised lending which are vital to economic recovery, becoming uneconomic.

The EBA has previously acknowledged the benefits of having a risk sensitive capital framework (see the EBA's Discussion Paper on the Future of the IRB Approach) and AFME encourages the EBA to maintain this approach when carrying out its Level 2 work, including the various RTSs and other products in the pipeline related to the IRB approach.

Therefore, rather than extending its use under the IRB approach, AFME considers that slotting may be more useful in the context of the Standardised Approach, including in particular in the context of the BCBS proposals for a Revised Standardised Approach for credit risk where firms do not measure underlying risk levels for regulatory capital purposes. In this case, slotting could be used as a replacement for the risk insensitive proposals for specialised lending exposures set out by the BCBS<sup>1</sup>. This would be particularly helpful if the slotting approach itself is sufficiently risk sensitive and tailored to recognise the specific characteristics of the underlying exposures. At the same time, the slotting approach will need to be balanced as, the more sophisticated these approaches are, the more complicated they become, potentially losing some of their appeal in terms of simplicity.

We would be happy to share industry level data on the risk profile of certain categories of specialised lending exposures with the EBA in the context of the development of the future IRB and SA approaches should this be useful to help the EBA progress its thinking in these areas.

**Question 2:** *What would be the preferred approach for the combination of the factors into a final assignment to a category? What are the advantages and drawbacks of either approach? What would be the impact of both options on capital requirements? Are both options equally clear or should further guidance be provided? Are there other approaches that could be used to harmonise how the different factors are combined into a final assignment for the risk weight?*

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<sup>1</sup> See the industry's response to the Basel Committee's proposals for a revised Standardised Approach for Credit Risk for further information on our views on the proposed treatment for specialised lending exposures.

In practice, not all of the factors set out in the draft RTS carry equal weighting in an institution's credit assessment and a weaker score in one particular factor can be compensated or mitigated by the strength of another factor. Differing loan structures and asset characteristics depend on different slotting factors and no single factor should be allowed to "contaminate" the entire structure as would be the case under option 1.

Indeed, option 1 could result in unduly conservative outcomes because the factor deemed to be the weakest can play disproportionate role, ultimately driving the final assessment, even if it is of little or no relevance to the overall risk of the underlying exposure. For the same reasons, option 1 is inconsistent with firms' credit assessments and underwriting practices as again, if the weakest factor is not a decisive factor, or if firms have taken mitigation measures, this factor may be irrelevant in the firms' decision making.

By way of example, the '*financial strength*' factor covers a number of key sub-factors, some of which, depending on an institution's approach to risk assessment in the sector, in isolation may influence the wider weighting of the deal. For instance, DSCR, LTV and Debt Yield are key and carry a significant weight for the slotting of real estate exposures. On the contrary, while '*sponsor strength*' can be a relevant factor, without any contractual obligations, it cannot be assumed that a sponsor would support a loan or structure under all circumstances. For that reason, unless contractual support is present, the strength of the sponsor should not have equal weighting to some of the more tangible factors and sub-factors under the '*financial strength*' umbrella. The latter ultimately have more weight in a firm's assessment. Additionally, while firms may consider the equity of the sponsor in a deal, the net worth and liquidity of the sponsor are of lesser relevance because sponsors are often not contractually required to maintain their net worth and liquidity during a deal. Generally speaking, firms place emphasis on the nature of the deal structure, cash management and reserves in their credit assessments.

We therefore consider that the most appropriate approach is one that allows for a final assignment that best reflects the underlying risks of the transaction. For the reasons set out above, option 1 is not suitable. Moreover, option 1 is not consistent with CRR Article 173 which requires firms to adjust assignments in light of all available, material information.

Given the need for the final assessment to reflect the underlying risk of an exposure, we do not agree with the proposal to assign a minimum 10% weight to each factor under option 2. We recognise that the EBA wants to ensure that firms undertake a comprehensive assessment of the various criteria; however, a minimum 10% weight could result in the overestimation of the importance of a particular factor. Moreover, given that not all the factors or drivers may be meaningful, an arbitrary minimum weight may create difficulties when backtesting the results. The objective should therefore be to ensure that firms have duly considered each of the factors, but if a factor is proven to be less relevant (or totally irrelevant), firms should be allowed to assign appropriate weights accordingly. We therefore suggest that if the EBA ultimately decides to choose option 2 that no minimum be prescribed.

It would also be necessary to clarify in the final RTS whether firms can specify different risk weights for individual transactions rather than treating each class of specialised lending exposure in the same manner. For instance, shipping and aircraft finance both belong to the object finance category but will have different underlying deal and asset characteristics.

Lastly, we ask that the EBA also specifies in the final RTS whether firms can consider factors other than those listed in the proposals when they consider them to be relevant to assessing an exposure.

**Question 3:** *Do you agree with the classification of specialised lending exposures and the descriptions given?*

We agree with the proposed classification and descriptions.

We disagree however with the proposed method for determining the remaining maturity of the exposure as set out in Recital 4 of the draft RTS with reference to the risk weights set out in Table 1 of Article 153(5) of the CRR, i.e. that the applicable remaining maturity should be the higher of the contractual remaining maturity and the expected remaining maturity of the exposure. A change to the definition of remaining maturity is not part of the EBA's present mandate. Moreover, in order to retain consistency of the maturity concept between the slotting approach and the IRB and Standardised Approaches, and to avoid firms interpreting this concept differently, leading to incomparable outcomes between banks, the applicable remaining maturity must be the contractual maturity.

We also do not consider the final maturity of the underlying assets or project to be relevant for the application of the slotting approach given that the refinancing risks the EBA seems to be concerned about are addressed in the slotting criteria themselves. The key point in this respect is the sustainability of cash flows during and after the contractual lending period. Should refinancing risk increase during the contractual term of the exposure (e.g. due to deterioration of the underlying asset or project, or adverse movements in the refinancing market), it would result in slotting to a lower quality category (i.e. to a higher risk weight).

**Question 4:** *Do you agree with these documentation requirements for each specialised lending exposure for which risk weights are assigned according to this Regulation?*

We agree with the proposed documentation requirements.

**Question 5:** *Do you have any suggestions or comments on the assessment criteria for project finance?*

No.

**Question 6:** *Do you have any suggestions or comments on the assessment criteria for real estate?*

We refer the EBA to the recommendations of CREFC Europe for the criteria related to real estate exposures.

**Question 7:** *Do you have any suggestions or comments on the assessment criteria for object finance?*

No.

**Question 8:** *Do you have any suggestions or comments on the assessment criteria for commodities finance?*

No.

**Question 9:** *Do you have any suggestions or comments on the Impact Assessment?*

No.

***Other issues***

The timing of implementation of the proposed RTS is important and must be considered in the context of the broader package of RTSs and other regulatory developments that are currently in the pipeline in relation to the IRB approach. Indeed, these changes need to be factored into this broader timetable in a sequential manner. To minimise the burden for firms and avoid the disruptions caused by historical adjustments (see for instance AFME's response to the EBA's Discussion Paper on the Future of the IRB Approach), we suggest that the RTS be applied prospectively i.e. to new specialised lending exposures granted post adoption of the standard.

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