March 27, 2015

Filed electronically
William Coen
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002
Basel, Switzerland

Re: Consultative Document: Revisions to the Standardised Approach for credit risk (bcbs 307)

Dear Mr. Coen:

World Council of Credit Unions (World Council) appreciates the opportunity to comment on the Basel Committee’s Revisions to the Standardised Approach for credit risk consultative document (bcbs 307). Credit unions are cooperative depository institutions that operate to promote thrift and financial inclusion and World Council is the leading trade association and development organization for the international credit union movement. Worldwide, there are 57,000 credit unions in 103 countries with USD 1.7 trillion in total assets serving 208 million natural person members.

Basel III risk-based capital standards apply to credit unions in some jurisdictions—including Australia and Canada—and even though credit unions in many other jurisdictions (including the European Union and the United States of America) are not subject to Basel III per se, they often do business with Basel III-compliant banks or are subject to supervisory standards modeled on Basel III.

World Council supports revising aspects of the standardised approach that did not perform well during the financial crisis, but we are concerned that the proposal would negatively impact credit unions in number of respects, as outlined below. World Council also strongly supports the comments of the Customer Owned Banking Association (COBA) of Australia filed in response to this consultation.

Summary of World Council’s Comments

• Debt-Service Coverage Ratio in Mortgage Lending: We do not support the proposed use of a Debt Service Coverage (DSC) ratio for residential mortgage exposure weightings in jurisdictions that do not commonly use the DSC ratio in mortgage

3 COBA’s comment letter in response to this consultation can be accessed at this URL: http://www.customerownedbanking.asn.au/media-a-resources/submissions-download-submissions-and-sign-up-for-alerts.
underwriting. The proposed use of the DSC ratio appears to be based on United States and Canadian mortgage underwriting standards (specifically the so-called “back-end ratio”) and is not consistent with how credit unions underwrite mortgages in other jurisdictions such as Australia and Europe. Credit union mortgages made in Australia and elsewhere perform well and we do not think that credit unions outside of North America should be required to change their mortgage underwriting standards to conform to North American norms in order to perform risk-based capital calculations.

In addition, the predictive power of both the DSC and LTV ratios are highly context specific and may not be as meaningful in property markets outside of North America.

- **CET1 Ratio in Interbank Lending Risk Weightings**: We strongly oppose using the capital adequacy ratio of Common Equity Tier 1 (CET1) capital to risk-weighted assets (RWA) as a risk criterion for interbank lending, as well as the proposed 300% risk-weight for loans to non-Basel III-compliant institutions (unless they choose to apply Basel III de facto so that they can determine their RWA) because the use of the CET1/RWA ratio will disadvantage credit unions that are not subject to Basel III.

The vast majority of credit union capital is in the form of CET1 retained earnings, and credit unions are typically better capitalized than Basel III-compliant banks and more conservatively run from a risk management standpoint because they focus on providing retail banking services at reasonable rates. We believe that the Basel III leverage ratio would be a more appropriate measure than the CET1/RWA ratio.

- **Mortgage Guarantees**: We request clarification that mortgages guaranteed by sovereigns or through private-sector guarantees (such as “Lenders Mortgage Insurance” or “Private Mortgage Insurance”) will result in reductions of risk-weightings as described in Paragraphs 126 through 138 of Annex I. As proposed, Sections 2.5 and 3.3 of the guidance are not clear regarding whether Paragraphs 126 through 138 of Annex I apply to residential mortgages or other loans.

- **SME Lending**: We are also concerned that the proposed treatment of loans made to corporates will further reduce Small and Medium Enterprises (SMEs) lending. Most credit union business loans are made to SMEs and SMEs are the drivers of many economies and the primary source of new jobs and economic growth. We urge the Committee to increase the proposed SME definition’s annual revenue component from up to EUR 5 million to up to EUR 50 million, as SMEs are defined in general under Basel II/III and in the European Union, and also believe that loans to SMEs should receive reasonable risk-weights as a public policy matter in order not to restrict further these businesses’ already limited access to credit.

World Council’s detailed comments concerning these issues as well as other aspects of the proposal are below.
World Council’s Detailed Comments

Q1. What are respondents’ views on the selection of the capital adequacy ratio? In particular, is the CET1 ratio superior to the Tier 1 ratio or the Leverage ratio? Do respondents agree that it is necessary to require calculations in accordance with Basel III in order to ensure a consistent implementation?

We believe that the Basel III leverage ratio of total Tier 1 capital to total assets would be a more appropriate proxy for banking institutions’ financial health than the CET1/RWA capital adequacy ratio. The leverage ratio can be more easily applied to institutions that are not subject to Basel III and would also ensure consistent implementation across different types of institutions and different jurisdictions.

Unless the Committee amends the proposal to use the Basel III leverage ratio, the proposed approach would likely effectively shut non-Basel III credit unions out of the interbank lending market despite these credit unions’ high levels of high quality capital and their conservative operating philosophy. This includes credit unions in the European Union (EU), which are exempt from the EU’s CRD IV capital requirements directive, as well as the majority of credit unions in the United States, Latin America, Africa and Asia. Alternatively, these credit unions that are not subject to Basel III would de facto be required to adopt Basel III and assume its myriad compliance burdens simply in order to obtain interbank loans at reasonable rates, or be subject to a 300% risk-weighting instead of a risk-weights as low as 30%.

We also think that the Basel III leverage ratio is less susceptible to capital arbitrage than were the pre-Basel I leverage ratios used in the 1980s and before. Today’s Basel III leverage ratio exists in parallel with the three Basel III risk-based capital ratios, meaning that banks’ efforts at capital arbitrage today are generally aimed at manipulation of RWA as opposed to banks’ pre-Basel I approach to capital arbitrage of investing in risky assets because there was no risk-based approach to capital regulation.

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RWA can be misleading, as the proposal notes. Commercial banks often seek to maximize their return on capital by investing in the highest yielding assets available in a particular Basel risk-weight class. Prior to the financial crisis the majority of asset-based securities invested in by banks had AAA ratings, presumably because these bonds only required the banks to hold 20 percent as much capital as they would have had to hold against a BB-rated bond. As is well known, many of these AAA-rated bonds had different yields and many turned out to be of poor credit quality despite their perceived low risk, especially the higher yielding ones. For example, AAA-rated mortgage-back security (MBS) senior mezzanine tranches typically had higher yields and higher losses than AAA-rated super senior MBS tranches, but both were treated the same for regulatory capital purposes under the Basel II standardised approach. Although this proposal seeks to eliminate this particular avenue for capital arbitrage by moving away from credit ratings, it is likely that bankers in the future will similarly seek to maximize their return on capital to the greatest extent possible under Basel III.

This likely unavoidable form of capital arbitrage by bankers focused on short-term returns undermines the Basel framework’s effectiveness because these higher yielding assets typically have lower real-life credit quality than their standardised risk-weights would suggest (which is why they have a higher yield). Using the CET1/RWA capital adequacy ratio for interbank lending could therefore further distort the interbank lending market by giving artificially low rates to banks that are in reality riskier than their RWA would suggest, in addition to disadvantaging the generally less complex and more conservatively run credit unions and other financial institutions that are not subject to Basel III.

Q2. Do respondents believe the net NPA ratio is an effective measure for distinguishing a bank exposure’s credit risk? What alternative asset quality measure, if any, should be considered by the Committee?

Considering a banking institution’s net non-performing assets (NPA) ratio in isolation would be a reasonable approach to distinguishing a bank exposure’s credit risk, however, we question whether consideration of the net NPA ratio is necessary when banks have established adequate loss reserves for these assets and the bank’s leverage or capital ratio is also part of the credit risk analysis. The allowances for loan and investment losses are provisioned out of regulatory capital (usually out of CET1 unless CET1 is exhausted), meaning that a bank’s NPA are indirectly reflected in the bank’s leverage ratio and capital adequacy ratio because the existence of NPA lowers these ratios.

We recognize that provisioning for the allowances for loan and investment losses can currently vary from jurisdiction-to-jurisdiction because of differing accounting standards. Also, these accounting standards typically do not specify a particular number of days that a loan is in arrears before the bank must provision for it, and similar timing discrepancies can exist for other-than-temporary impairment of investments.

The Basel Committee has recently proposed a solution to these jurisdictional differences, however, in the form of the *Guidance on accounting for expected credit losses - consultative document* which, among other things, would require banks to provision for a loan after 90 days of arrearage or sooner. The

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Committee finalizing its proposed guidance on accounting for expected credit losses should reduce significantly the jurisdictional differences associated with credit loss provisioning.

We are also concerned about the data quality and regulatory burden of net NPA ratio calculations in jurisdictions that do not publish financial institutions’ financial reports online or elsewhere on a quarterly basis. In these jurisdictions the lending bank’s counterparty would presumably be expected to provide the figures necessary to calculate its net NPA ratio. This would be an added burden on the borrowing institution’s management and, more significantly from a safety and soundness standpoint, the proposal does not appear to contemplate controls that would prevent an institution from manipulating this data unless the lending bank were to obtain these figures from the borrower’s supervisor.

Q3: Do respondents have views on the proposed treatment for short-term interbank claims?

We support reducing the risk-weight of short-term exposures by at least 20%, but do not support the proposal to exclude non-Basel III institutions from this preferential treatment for the reasons discussed above in response to Question 1 and below in response to Question 4.

Q4. Do respondents have suggestions on how to address these concerns on the treatment of exposures to banks? In particular, do respondents have views on how to treat exposures to banks not subject to Basel III in a consistent and risk-sensitive manner?

We strongly urge the Committee to make reasonable accommodations for institutions that are not subject to Basel III—including using the Basel III leverage ratio to gauge risk in the interbank lending context—because these institutions contribute importantly to a diverse and stable financial sector, and promote the financial inclusion of unbanked and underbanked people.

We believe that the Basel III leverage ratio would be an appropriate approach to assessing exposures to banks and credit unions not subject to Basel III in a consistent and risk-sensitive manner, as discussed above in response to Question 1. Credit unions not subject to Basel III typically must have a leverage ratio higher than the 3 percent Basel III leverage ratio (except in the case of newly chartered credit unions), and sometimes credit unions’ leverage ratio requirements are more than the twice the Basel III leverage ratio (i.e. more than 6 percent Tier 1 capital to total assets) the Financial Stability Board has proposed for Global-Systemically Important Banks (G-SIBs). For example, most credit unions in the United States must have a leverage ratio of 7 percent to be “well capitalized” and credit unions in the Republic of Ireland must typically have a leverage ratio of 10 percent. In addition, credit unions exist to promote thrift and financial inclusion, meaning that interbank lending rules unfavorable to credit unions will negatively impact credit unions’ natural person member-owners, many of whom are of modest means.

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We think that it is essential for the Committee to specify that the Basel III leverage ratio should be used to assess interbank lending risks associated with banks and credit unions not subject to Basel III, whether or not the Committee chooses to use the leverage ratio or CET1/RWA capital adequacy ratio for Basel III-compliant institutions. Without providing an easily applicable method of analysis for interbank lending to institutions not subject to Basel III, non-Basel III institutions will either need to adopt Basel III de facto or be subject to a punitive 300% risk weight.

We also do not support the proposed 300% risk-weight for non-Basel III institutions, which is a stark and seemingly arbitrary contrast to the risk-weights as low as 30% available to Basel III-complaint institutions. In addition, even the 30% risk-weight would be higher than the 20% risk-weight currently assigned to many Basel III-compliant credit unions’ interbank loans.

Whether or not a credit union is subject to Basel III, the proposed approach would further distort the interbank lending market in favor of G-SIBs which already enjoy artificially low interbank lending rates because the market believes that these G-SIB institutions have de facto government guarantees. We do not believe that punishing less complex, well capitalized, community financial institutions like credit unions, while further subsidizing G-SIBs, is in the public interest.

Question 5: Do respondents have views on the selection of risk drivers and their definition, in particular as regards leverage and the incorporation of off-balance sheet exposures within the ratio? Would other risk drivers better reflect the credit risk of corporate exposures?

We believe that the risk drivers identified by the Committee appear reasonable, although we are concerned that it may be challenging for credit unions to obtain the data necessary to use the look-up tables included in the proposal. We urge the Committee to consider establishing a risk-weight that is lower than the punitive 300% rate applicable to situations where this data is not readily available, at least with respect to SME loans.

Q6. Do respondents have views on the appropriateness of the proposed treatment, especially with regard to SMEs? And about the more lenient treatment for start-up companies?

World Council supports lower risk weights for SMEs and startups, including start-ups receiving a 110% risk weighting (rather than 300%) in their first year and where no year-end revenue data exist. We question, however, whether the definition of SME should be limited to institutions with less than EUR 5 million in revenue when the SME definition used in Basel II/III in general is annual revenue of less than EUR 50 million and the EU definition of SME applies to corporates with up to 250 employees and less than EUR 50 million in annual revenue.10

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With respect to SME lending generally, there is a strong consensus among credit unions and most policymakers that SMEs are core engines of economic growth, new jobs, and innovation. Excessively stringent SME lending rules risk significantly reducing the SME sector’s access to credit. Tight credit for SMEs harms the economy in general and, by extension, the banking sector since an economic downturn inevitably leads to more and greater loan losses than would otherwise occur.

SMEs’ lack of access to credit from private sector banks and credit unions also often leads to policy solutions involving governments lending directly to SMEs and/or guaranteeing SME loans. These solutions to the unintended consequences of regulation expose the government more directly to losses related to SMEs than if banks and credit unions had made normal business loans to these companies.

In Canada, for example, the solution to SMEs’ lack of access to credit has often been to channel funding to SMEs through state-owned enterprises or loan guarantee programs. In other words the consequence of well-intended regulations to mitigate the financial risk to taxpayers stemming from banks’ and credit unions’ exposure to SME loans simply push the problem to a different level of government: Either governments take the loans onto their own books via these state-owned entities or offer loan guarantees that amount to the same thing, or they do both.

In addition, using state-owned enterprises to provide SME lending further distorts markets by introducing a state-subsidized competitor to private-sector banks and credit unions that crowds private-sector institutions out of the SME lending business.

We believe that an SME definition for Basel III lending purposes that is consistent with the general Basel II/III SME definition of annual revenue up to EUR 50 million and the EU SME definition of corporates with fewer than 250 employees and annual revenue up to EUR 50 million would be better public policy and result in stronger and more robust economies that, by extension, support healthier banking institutions.

**Q10. Do respondents agree that LTV and/or DSC ratios (as defined in Annex 1 paragraphs 40 and 41) have sufficient predictive power of loan default and/or loss incurred for exposures secured on residential real estate?**

We do not support the proposed use of a Debt Service Coverage (DSC) ratio for residential mortgage exposure weightings in jurisdictions that do not commonly use DSC in mortgage underwriting.

In jurisdictions that do not commonly use the DSC ratio, the use of DSC for Basel III risk-weighting purposes would present an undue regulatory burden because credit unions and other mortgage lenders would be required to adjust their largely safe and sound mortgage underwriting standards only for Basel III risk-weighting purposes, and would also not have the data to weight their existing mortgages in a manner consistent with the proposal.

The proposed use of DSC also appears to be based on United States and Canadian mortgage underwriting standards (specifically the so-called “back-end ratio”) and is not consistent with how
credit unions underwrite mortgages in other jurisdictions, such as Australia and Europe, where measures such as the borrower’s net disposable income are more commonly used.

In addition, we have heard conflicting views from credit unions that use the DSC and LTV ratios in mortgage underwriting on whether DSC and LTV ratios have good predictive value: Some credit unions believe that these measures have good predictive value while others believe that macroeconomic and life-event causes such as unemployment and divorce are more relevant.

DSC and LTV are also highly context specific in terms of predictive power: DSC and LTV ratios that are meaningful in the US or Canadian mortgage market may not have sufficient predictive power of loan default in different mortgage markets, such as those in Australia and Europe. (Credit unions in Latin America, Africa, and Asia do not typically engage in purchase-money mortgage lending, and only larger European credit unions make purchase-money mortgages).

Credit union mortgages made in Australia and elsewhere outside of North America perform well and we do not think that credit unions in jurisdictions other than the United States and Canada should be required to change their mortgage underwriting standards to conform to North American norms in order to perform risk-based capital calculations. We note also that mortgages made largely by US commercial banks and US non-bank lenders contributed significantly to the Global Financial Crisis, whereas mortgages made in other jurisdictions and by US credit unions did not.

In Australia, credit unions use a “net income” underwriting model (i.e. the borrower’s net income after expenses) rather than DSC, and the relatively few, large credit unions in Europe that make first-lien mortgages use a similar approach.

Although we do not have data on European credit union mortgage lending because of their limited mortgage lending volume, mortgage lending by Australian mutuals—i.e. credit unions and building societies (CUBS)—has historically been more sound than mortgages made by other Australian mortgage lenders. (This appears to be true also for credit union originated mortgages in general compared to mortgages made by other lenders, including in the United States and Canada.)

On the following page is a chart comparing 90-days-plus delinquent mortgage loans made by Australian CUBS to 90-days-plus delinquent mortgage loans made by the four major Australian banks, as a percentage of total mortgage loans originated by these institutions and securitized, between December 2007 and December 2013:
As the chart demonstrates, mortgages made by Australian CUBS and by large Australian banks have performed very well historically, with 90-day-plus delinquent loans below 0.60%, although the CUBS mortgages have generally performed better than those made by banks. By way of comparison, delinquency rates on mortgages made by US credit unions were also relatively low over the same period, but not as low as those in Australia even after the end of the Global Financial Crisis and the US “Great Recession”:

(Source of data: Credit Union National Association of the USA, Recent Credit Union Trends (2014) and US Credit Union Profile – End-Year 2014, at 9 (2015))
As the data shows, DSC and LTV ratios are not magic bullets with respect to mortgage lending and mortgage underwriting standards using alternatives to the DSC ratio—such as the “net income” approach used by Australian CUBS—can perform better than DSC and LTV measures even with respect to mortgages originated by financial institutions that have similar corporate structures and similarly conservative operating philosophies.

We do not support the use of the DSC ratio with respect to risk-based capital measures in jurisdictions where DSC is not commonly used in mortgage underwriting standards. This would represent an unreasonable regulatory burden on credit unions and other mortgage lenders in these jurisdictions. We urge the Committee to incorporate alternatives to the DSC ratio into this standard, such as the borrower’s “net income,” for jurisdictions that do not commonly use DSC in mortgage underwriting.

We also believe that the DSC and LTV ratios are also highly context specific in terms of predictive power and believe that their predictive power outside of North America (and even in North America) may be limited.

QII. Do respondents have views about the measurement of the LTV and DSC ratios? (In particular, as regards keeping the value of the property constant as measured at origination in the calculation of the LTV ratio; and not updating the DSC ratio over time.)

We support the proposal not to require financial institutions to revalue residential real estate for LTV ratio purposes after origination and not to require institutions to update the borrower’s DSC ratio after origination (if the DSC element is indeed finalized, which we think would be inappropriate with respect to jurisdictions that do not commonly use DSC in mortgage underwriting). As the proposal correctly states, requiring institutions to update these figures would be an unreasonable regulatory burden and would introduce excessive pro-cyclicality to mortgage-related risk weightings.

We urge the Committee, however, to allow financial institutions the option to reassess these measures after loan origination, as they would be able to do if they refinanced the mortgage loan. Without the option to reassess the mortgage’s LTV and DSC ratios (or other borrower income measure) institutions would in some cases have a strong incentive to refinance mortgages to reduce their capital requirements. Requiring refinancing in order to reassess the mortgage’s risk weighting could result in consumers paying unnecessary fees and also undermine competitive neutrality for the institution holding the mortgage versus competing financial institutions employing the standardised approach that could refinance these loans at lower risk weights.

In addition, we believe that rental income should be included as part of the borrower’s income in the mortgage lending analysis. Rental income is a stable source of income in many jurisdictions. Failure to consider rental income as part of the borrower’s income in the underwriting process would also price most ordinary people out of the mortgage market for investment properties, which would significantly depress the value of residential real estate in general, especially in vacation areas, or cause real estate markets to lock up.
The approach of not considering rental income would also mean that only the very wealthy could invest in real estate other than their primary home, which would be contrary to public policy because it would further increase wealth inequality. While we recognize that non-owner-occupied properties present additional risks, a better approach would be to accord a higher risk-weight to these investment property mortgages that is commensurate with the default data on these loans.

**Q12. Do respondents have views on whether the use of a fixed threshold for the DSC ratio is an appropriate way for differentiating risks and ensuring comparability across jurisdictions? If not, what reasonably simple alternatives or modifications would respondents propose while maintaining consistent outcomes?**

We think that a fixed threshold for the DSC ratio is reasonable in jurisdictions that commonly employ DSC in mortgage underwriting. Fixed thresholds are currently the practice in Canada and the United States.

In jurisdictions that do not commonly use the DSC ratio in mortgage underwriting and instead look at “net income” or a similar measure, we think that the Committee should establish a parallel set of thresholds based on the non-DSC income measures. Consistent outcomes could be achieved by establishing a conversion equation to convert “net income” to DSC or vice versa.

**Q13. Do respondents propose any alternative/additional risk drivers for the Committee’s consideration in order to improve the risk sensitivity in this approach without unduly increasing complexity?**

As discussed above in response to Questions 10 and 12, we think that jurisdictions that do not commonly use the DSC ratio should be able to employ similar metrics which are commonly used in those jurisdictions, such as the borrower’s “net income.” Mortgage underwriting does need to use a metric that considers the borrower’s ability to repay, which is tied directly to income, but using the DSC ratio in jurisdictions that commonly use DSC in underwriting and “net income” in jurisdictions that commonly use “net income” in underwriting would introduce minimal complexity to these risk-weighting standards. Allowing one or more alternatives to DSC based on how mortgage underwriting is currently performed in different jurisdictions would still allow cross-jurisdictional comparability to a high degree, especially if the Committee were to develop a conversion equation to facilitate comparison of DSC underwritten mortgages vis-à-vis “net income” underwritten mortgages, and so forth.

We also request clarification that mortgages guaranteed by sovereigns or through private-sector guarantees (such as “Lenders Mortgage Insurance” or “Private Mortgage Insurance”) will result in reductions of risk-weightings as described in Paragraphs 126 through 138 of Annex I. As proposed, Sections 2.5 and 3.3 of the guidance are not clear regarding whether Paragraphs 126 through 138 of Annex I apply to residential mortgages or other loans.

We strongly support the concept of including sovereign guarantees and private sector guarantees in residential mortgage risk-weighting when these guarantees meet the requirements of Paragraphs 126 and 138 of Annex I, including the ability to substitute the credit risk weight assigned to the guarantor in such situations. These guarantees do in fact reduce credit unions’ credit risk exposure
to mortgages (often to 0% risk in the case of a sovereign guarantee) and there is no policy reason to
discount the existence of these guarantees.

**Question 14: Which of the two options above is viewed as the most suitable for
determining the risk-weight treatment for exposures secured on commercial real estate?**

With respect to commercial loans backed by real estate, which are currently treated with a 100% risk weighting, we support option B, which proposes to assign risk weighting ranging from between 75% and 120% based on LTV ratios.

**Question 19: What are respondents’ views on the alternative treatments currently envisaged for past-due loans?**

We support continued use of the flat-rate weighting given that the assessment of what constitutes a “past due loan” is consistent by asset type.

World Council appreciates the opportunity to comment on the Basel Committee’s proposed *Revisions to the Standardised Approach for credit risk guidance*. If you have questions about our comments, please feel free to contact me at medwards@woccu.org or +1-202-508-6755.

Sincerely,

Michael S. Edwards
VP and General Counsel
World Council of Credit Unions