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European Banking Authority
One Canada Square (Floor 46)
Canary Wharf
London E14 5AA

11th August 2015

Dear Sirs,

RESPONSE TO THE CONSULTATION ON DRAFT REGULATORY TECHNICAL STANDARDS ON ASSIGNING RISK WEIGHTS TO SPECIALISED LENDING EXPOSURES (EBA/CP/2015/09)

We thank the European Banking Authority ("the Authority") for the opportunity to respond to the consultation on the Draft Regulatory Technical Standards on Assigning Risk Weights to Specialised Lending Exposures under Article 153(9) of Regulation (EU) No 575/2013.

We support the Authority's broader intent to promote harmonisation in the assessment of risk for specialised lending exposures. We further agree that this could involve specifying a common set of indicators and conditions for use by the authorities across Member States for these exposures, and that developing clarity on how institutions shall take into account the prescribed risk factors in the assignment of risk weights could constitute a step towards that objective.

Standard Chartered has long experience with assigning risk weights to specialised lending exposures in line with Article 153(5). We have used the method, in the form of the supervisory slotting criteria approach in the Basel framework, for real estate exposures since 2008. Based on this experience, we believe that the draft regulatory technical standards in their current form may not accomplish the stated objective or may do so in a way that promotes unintended outcomes.

Key Concerns

We believe that the slotting approach and the proposed standards do tend towards greater comparability but that this comparability is achieved by blunting risk sensitivity. As a result, slotting may create greater challenges for risk management instead of enabling it.

Real estate is a highly localised industry, with local regulatory requirements, local market conventions and practices. To the extent that supervisory slotting involves a "one-size-fits-all" approach, it engenders challenges for banking groups with significant real estate specialised lending exposures across geographies. As an institution with long experience in managing real estate exposures in emerging markets, and not within the European Union, we would therefore not favour imposing a set of standards developed for different markets than the ones that we are involved in.

Accordingly, from a risk management perspective, we would prefer that firms be given more flexibility to interpret the slotting criteria rather than less. This need not be inimical to the aim of achieving comparability insofar as comparability in the range of capital requirements is already ensured by the limited number of supervisory slots.

We note that the EBA relates the problem definition to the potential for “uneven playing field” and “distortion in competition”. In our experience, these are reasonably well controlled when comparing different implementations of supervisory slotting because of the limited range and granularity of slotting risk weights. However, these effects are more apparent when slotting risk weights are compared with the risk weights from a full IRB PD/LGD calculation, which is not subject to the limitations of slotting. As such, if the concern is uneven playing field and distortion in competition, we would consider if the statement of the problem should in fact be broadened to the lack of a European harmonised framework in the interpretation of the conditions under which supervisory slotting should be applied.

Because of the risk weight limitations, we believe that supervisory slotting in its current implementation, and also under the approaches proposed in this consultation, may set unintuitive incentives by distorting the balance of risk and return between assets.

Summary

While comparability for the supervisory slotting approach is desirable, we have concerns that the cost of achieving comparability, by giving up risk differentiation and risk management capability, may have been underestimated. As such, we would propose that harmonisation of the supervisory slotting approach should not proceed beyond better defining the factors that firms should consider in making risk weight assignments.

We appreciate this opportunity to provide our comments on the consultation. Our responses to the specific questions set out in the consultation are included in the appendix. We would also like to refer the Authority to the responses of the British Bankers’ Association, to which we have contributed. We would be pleased to discuss the contents of this letter, and any related matters, with you at your request.

Yours sincerely,

Roselyne Renel
Group Chief Credit Officer

11 August 2015

Standard Chartered

APPENDIX – RESPONSES TO EBA/CP/2015/09

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, if yes, which types of exposures would this be particularly relevant for?

• We believe that the slotting approach does tend towards greater comparability but at the cost of blunting risk sensitivity, and that risk sensitivity is of greater benefit to firms and to the financial system than comparability.

Consider the example of two assets with respectively 15% and 50% LTV and three-year maturity; it should be immediately intuitive that the former constitutes significantly lower risk than the latter, yet both would be risk weighted at the same 70% 'strong' category. The outcome numbers appear comparable, but the underlying risk differentiation has been cast aside to achieve that apparent comparability. In like vein, applying a 100% risk weight on all assets may be the most comparable, but is not meaningfully comparable.

Operationally, we also find that the 'cliff effects' of slotting interfere with setting the right risk incentives for origination. For example, under a full IRB approach, incrementally higher levels of qualifying collateralisation will always deliver incrementally positive benefits for pricing and risk management; in contrast, slotting on its own does not incentivise increasing collateralisation levels beyond set thresholds. Furthermore, our experience shows that slotting with its artificial flooring generates capital requirements that are disproportionate to our internal experience and to other IRB exposures, which often distorts business and risk management decisions.

Accordingly, we would urge that the slotting approach should be restricted to asset classes where risk assessment is most doubtful, and extended only as a last resort.

• Real estate is a highly localised industry, with local regulatory requirements, local market conventions and practices. Banking groups with significant real estate specialised lending exposures across geographies (which may be outside the EU) face challenges with international applicability when slotting is used. To mitigate the risk that a global standard may be inappropriate in parts for local markets, we would urge considerable allowance for the context in which the slotting decision is being made.

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 drawback of either approach? 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?

• We do not support either option, but would especially caution against Option 1. The nature of bank lending is such that, particularly at origination, it is usually the case that areas perceived to be weaker have to be compensated for by strengths in other areas. For example, an inferior location may be mitigated by longer tenant lease profile, or stronger sponsors may seek (and obtain) higher LTV ratios. Therefore we would caution against a "weakest link" approach as in Option 1 that might end up treating an

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exposure with 3-4 significant weaknesses as being equivalent to an exposure with just one significant weakness mitigated by considerable strengths.

- We would support the policy choice of leaving the weighting scheme to firms to choose (which is more consistent with slotting being still within the IRB approach), subject to the agreement of national regulators. We believe that the harmonisation of the slotting criteria on its own is sufficient to fulfil Article 153(9).

In making this statement, we consider that there are numerous possible weighting options beyond the two proposed. For example, a weighting scheme that incorporates the slotting criteria text into a full model that states the risk in terms of PD/LGD and then maps these risk outputs into the slotting categories will achieve the objective of an internally consistent weighting of the criteria, but can further reap the advantage of articulating risk in metrics that align with the rest of the IRB book to facilitate comparability within the firm. In this way, a firm can solve the problem of slotting not having the same risk language as the rest of the IRB approaches, and enable real risk differentiation for credit decisioning even if not for capital.

We believe this "best of both worlds" answer enables risk-sensitivity and gaining experience in modelling the asset class while addressing regulatory concerns on its modellability.

- We would further propose that the slotting criteria be considered minimum standards to be included in the slotting assignation and not the only standard, as long as firms are able to articulate to the satisfaction of national regulators why any additional information is relevant for improving discriminatory capability in the slotting assignations.

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

- We are broadly in agreement with the proposed definition for specialised lending exposure that qualifies as real estate.

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 documentation requirements of specialised lending exposures subject to supervisory slotting.

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

- We observe that, from a technical modelling perspective, there are some aspects of the proposed assessment criteria that are sub-optimal for good risk discrimination. Specifically:

  - There are no distinctions made between Category 1 and 2 (and 3 in some instances) for several sub-factors. We believe this would result in even less meaningful discrimination and even less comparability of risk weights simultaneously.

- Qualitative factors should be designed to be as mutually exclusive as possible to avoid multiple redundancy between questions. The proposed slotting answers display a propensity to mix information between factors and sub-factors.

  For example, 'Financial Strength (a): Market Conditions' mixes market conditions with asset quality ("The project's design and capabilities may not be state of the art compared to new projects") and cash-flow predictability ("The project is losing tenants at lease expiration").

  Also, in the 'Asset Characteristics (a): Location' sub-factor, the property's "configuration, design and maintenance" have no bearing on its location, and repeats information in 'Asset Characteristics (b): Design and condition'. This should be redefined, e.g. by rewording to "The property is situated in an undesirable location".

- In general, we note that the assignment criteria are especially ill-defined for property under construction. For example, these property loans would also run development risk compared to investment loans against completed properties, although the level of development risk tends to diminish as construction progresses, but this is not considered in the proposed assignment criteria.

Furthermore, for 'Asset Characteristics (c): Property is under construction', it is important to consider the credit standing of the contractor in addition to its qualification. These contractors may not be the firm's clients and financial information may not be available for a detailed assessment, however there should be trade checks and monitoring of any adverse/negative news on the contractor. Experience in the real estate industry suggests that contractor failure can have severe impacts on construction projects.

- We further highlight that the assignment criteria do not consider hospitality assets, and, particularly in the case of 'Financial Strength (e): Cash-flow predictability', may be inappropriate for these assets.

- The comments that follow within this section are contributed by the bank's real estate experts and address specific factors or sub-factors:

  - On 'Financial Strength (a): Market Conditions', we note that the reference back to previous lease terms may increase pro-cyclicality, and also that lease terms may change for reasons unrelated to market conditions. Furthermore, market conditions may be of little relevance for assets with a strong, high-quality and long-dated income stream, e.g. long lease to a government agency.

  - On 'Financial Strength (b): Financial Ratios': while the level of ICR/DSCR might provide a useful benchmark of the gearing and margin of safety, once debt levels are equalised it is often a reflection of asset/tenant quality, or even asset type and location. Better quality assets/tenants will be lower yielding, whereas higher yielding assets may be poorer quality and effectively higher risk.

    It is unclear what is intended by "DSCR or ICR is not relevant for the construction phase", for instance whether it means this sub-factor should be zero-weighted for in-construction properties or that the sub-factor should be scored 1 or 2 for in-construction properties.

We note that the Category 3 and 4 answers represent history whereas Category 1 and 2 represent states, and that it is therefore possible for Category 2 and 3 for instance to be simultaneously correct for an exposure whose ratios have deteriorated but are still considered satisfactory.

• On 'Financial Strength (c): Advance Ratio (LTV)', we note that LTV interpretation is dependent on cultural or policy elements. For instance, an LTV of 70% in Western markets may be considered Category 1, but in many Asian markets would be considered only Category 2 or Category 3.

Unlike the other answers, Category 3 is not a state but a history. For instance, if the value of the property has fallen 20% such that LTV has accordingly increased from 30% to 37.5%, this should not be a cause for concern. But as it is currently written, this case would be classed Category 3. We would accordingly suggest rewording it to "The property's LTV is considered marginally acceptable."

In general, we would discourage an evaluation of LTV that requires bucketing exposures into judgemental assessments of "low" and "satisfactory", which will mean different things to different credit experts in different markets. Instead, we would encourage a continuous evaluation of LTV that gives incremental benefit for every further reduction in LTV, as this would help to set incentives towards minimising risk.

• On 'Financial Strength (d): Stress analysis', we note that stress analysis based on cashflow is less optimal for single asset / single tenant transactions because of the binary outcomes: the income is either available or not. On the other hand, referencing the wider resources around the asset might introduce redundancy with other (e.g. sponsor) factors.

We do not believe capital expenditures to be a good benchmark to use, as it may not be relevant or material for all real estate specialised lending exposures. We would accordingly suggest rewording the Category 3 answer to "During an economic downturn, the property would suffer a decline in revenue that would significantly increase the risk of default".

The Category 4 answer does not read like a stress analysis but an indicator of existing stress. We would suggest rewording the answer to "The property's financial condition is strained and is likely to default if economic conditions deteriorate."

• On 'Financial Strength (e): Cash-flow predictability', we note that for properties under construction, the requirement for 100% pre-leasing commitment under Category 1 and 2 may be too onerous and unrealistic in many markets. More granularity is required in the assessment of pre-leasing commitments for properties under development, eg. it may not make sense for retail malls to be fully pre-leased on day one. It may also be appropriate to consider whether inclusion of a diversified pool of tenants/buyers (eg. residential projects for sale / retail malls for lease) may be a realistic alternative to creditworthiness assessments.

• On 'Political and legal environment', it may be useful to consider the level and frequency of government intervention in the real estate market (ie. policy risk) in addition to ease of repossession and enforcement.

•	On ‘Strength of sponsor / developer (a): Financial capacity and willingness to support the property’, there are instances where the contribution from the sponsor is in the form of land. Restricting the consideration to cash contribution (or equivalently judging land contribution as non-cash) could provide skewed incentives, particularly in city-centre markets where the value of the land contribution may significantly exceed the cash contribution required to develop an asset. We would accordingly suggest rewording “substantial cash contribution” to “substantial equity contribution”.

Nevertheless, this sub-factor is difficult to assess on older-vintage assets. For instance, should the metric be the original contribution to the construction or purchase of the property even if this occurred ten years ago? How is contribution measured if the proposed asset is a refinance of another lender? If in the process of refinance there is equity withdrawal (but still a healthy LTV buffer), is this a negative contribution? However, if contribution is not a day-one measure but an ongoing assessment, is the contribution revalued as embedded equity, in which case this factor may become procyclical?

•	On ‘Security Package (a): Nature of lien’, while it is preferred that lenders are provided with first legal mortgage over the subject properties being financed, there are instances where negative pledge is given to the lenders as the only creditors of the SPV with restriction on further indebtedness. This could be used to add discrimination to the currently undifferentiated Category 1 to Category 3 answers.

•	On ‘Security Package (a): Assignment of rents’, we believe the security package is overweighted towards assignment of leases. Other covenant packages can achieve similar aims, for example pledge of accounts, cash through-put requirements, share pledges or POAs. For development properties sold off-the-plan, the bank would typically require stage payments to be held in escrow at the bank, which is as good as assignment of rents. Also, the security package section does not currently take into account development security – contractors bonds, step-in rights etc. – which give the bank additional protection.

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

•	The EBA relates the problem definition to the potential for “uneven playing field” and “distortion in competition” effects. Considering the skew in the distribution of exposures under slotting (“58.6% of SL exposures under slotting are reported by UK banks”), it would be pertinent to understand whether there are systematic differences between the risk weights derived from supervisory slotting versus those derived purely from internal bank models. Once this is known, it may be useful to consider if the statement of the problem should in fact be broadened to the lack of a European harmonised framework in the interpretation of the conditions under which supervisory slotting should be applied.

•	We adjudge that rebuilding our rating systems to align with the new RTS will involve significant time, cost and effort, but will likely produce immaterial changes to the risk weights in our portfolio. As such, the new RTS is unlikely to deliver increased comparability over and above the existing comparability available from the restricted range and granularity of supervisory slotting risk weights. We would conclude therefore that the costs of the exercise have been underestimated and the benefits overestimated.

- We do not believe that the slotting approach, neither in its current implementation nor in its proposed implementation, contributes to greater meaningful consistency of capital requirements because of the highly heterogenous nature of the specialised lending classes and the amount of contextual interpretation involved in performing the assignations.