World Council

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

Re: Consultative Document: *Simplified alternative to the standardised approach to market risk capital requirements* (June 2017)

Dear Mr. Coen:

World Council of Credit Unions (World Council) appreciates the opportunity to comment on the Basel Committee on Banking Supervision's consultative document *Simplified alternative to the standardised approach to market risk capital requirements*.[1] Credit unions are cooperative depository institutions and World Council is the leading trade association and development organization for the international credit union movement. Worldwide, there are over 60,000 credit unions in 109 countries with USD 1.8 trillion in total assets serving 223 million physical person members.[2]

World Council supports the Committee's proposal of a "Simplified Alternative" to Basel III's standardised approach to market risk capital requirements, such as interest rate risk and foreign exchange risk in a depository institution's trading book, including the proposed removal of the Vega and Curvature risk calculations.[3] A Simplified Alternative to market risk would reduce regulatory burdens in a proportional manner and facilitate adoption of Basel standards by community-based cooperative financial institutions including credit unions. Currently, the more complex standardised approach is the least burdensome Basel III approach for financial institutions to control for market risk in the trading book.

We urge the Committee, however, to revise the final version of the Simplified Approach to make it more consistent with the principle of proportionality and less burdensome for community-based depository institutions by:

- Allowing non-complex depository institutions up to EUR 10 billion in assets and with trading books up to 10 percent of risk-weighted assets to utilize the Simplified Alternative;

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[1] Basel Committee on Banking Supervision, *Simplified alternative to the standardised approach to market risk capital requirements* – Consultative Document (June 2017), *available at* http://www.bis.org/bcbs/publ/d408.htm.
[2] World Council of Credit Unions, *2015 Statistical Report* (2016), *available at* http://www.woccu.org/publications/statreport.
[3] The Basel III standardised approach to market risk requires the calculation of 3 different types of risk analysis (primarily for derivatives positions): Delta, Vega, and Curvature. Delta is a risk measure based on sensitivities of a bank's trading book positions to regulatory delta risk factors. Vega is an options sensitivity to the volatility of the underlying asset. Curvature is a risk measure which captures the incremental risk not captured by the delta risk of price changes in the value of an option.

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- Harmonizing the Simplified Alternative's risk weights for general interest rate risk, equity risk and commodities risk with those of the standardised approach to market risk;[4]

- Treating well-capitalized financial institutions as "investment grade" for purpose of Delta credit spread risk non-securitization exposures even when the institution has not had a credit rating assigned by a credit rating agency such as Fitch, Moody's, or S&P. Credit unions typically do not have credit ratings and the use of credit ratings for regulatory capital exposure purposes is disfavored or unlawful in some jurisdictions, such as the United States of America under the Dodd-Frank Act.[5] We believe that an institution's level of capitalization relative to its applicable capital requirements, as disclosed under Pillar 3 of Basel III or similar disclosure requirements, is a more appropriate measure of a counterparty's financial strength for regulatory capital purposes;

- Revising the proposal's dichotomy between "advanced economies" and "emerging markets" to include the Republic of Korea and the all European Union Member States as "advanced economies;" and

- Clarifying that the Simplified Alternative market risk standard applies only to the institution's trading book, in order to reduce potential confusion by users of the standard.

1. Non-Complex Institutions up to EUR 10 Billion in Assets Should Use the Simplified Alternative

World Council urges the Committee to revise the threshold requirements for institutions eligible to utilize the Simplified Alternative to market risk to allow non-complex depository institutions with up to EUR 10 billion in assets and trading books up to 10 percent of risk-weighted assets to use this standard.

The trading books of credit unions and similar community-based financial cooperatives are usually non-complex compared to similarly sized commercial banks, based on the make-up of assets and liabilities, because credit unions are typically subject to stringent investment portfolio shaping rules that limit their permissible investments primarily to loans to members, bank deposits, and government-guaranteed debt instruments.

[4] *See* Basel Committee on Banking Supervisions, *Minimum capital requirements for market risk* (Jan. 2016), *available at* http://www.bis.org/bcbs/publ/d352.pdf.
[5] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, § 939A (July 21, 2010) ("MODIFICATIONS REQUIRED.—Each such agency shall modify any such regulations . . . to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations. In making such determination, such agencies shall seek to establish, to the extent feasible, uniform standards of credit-worthiness for use by each such agency, taking into account the entities regulated by each such agency and the purposes for which such entities would rely on such standards of credit-worthiness.").

Credit union exposures to derivatives are uncommon and, when allowed under the applicable rulebook, are typically limited to interest rate swaps and caps. Credit unions usually also only operate in one country because of their “common bond” restrictions on membership, meaning that foreign currency exposures are also uncommon. When foreign currency exposures exist, they are usually limited to foreign currency-denominated correspondent bank accounts used by credit unions to facilitate international electronic payments on behalf of their members.

We believe that the proposed maximum EUR 1 billion in assets and trading book of 5 percent of risk-weighted assets eligibility criteria—in addition to other proposed limitations on which institutions can use the Simplified Alternative, such as that the institution cannot be systemically important and cannot use Basel III’s internal modeling approaches—would unduly hinder the adoption of the Simplified Alternative for non-complex depository institutions, including most credit unions with less than EUR 10 billion in assets.

While these non-complex institutions’ trading books are generally relatively small, they can sometimes exceed 5 percent of risk-weighted assets during periods when an institution is changing its investment strategy (i.e. by moving investments from hold-to-maturity to available-for-sale in the short term in order to increase its lending capacity or acquire new hold-to-maturity investments over the long term) or if the credit union provides wealth management services to its physical person members on the members’ account (in which case the physical person member, not the credit union, is exposed to the assets’ market risk). We do not believe that either of these scenarios should disqualify a non-complex trading book institution with less than EUR 10 billion in assets from using the Simplified Alternative.

The level of interest rate risk and other market risks presented by these non-complex trading books is relatively straight forward and can be controlled for adequately using the Simplified Alternative. We do not believe that the standardised approach’s higher level of compliance burden, and attendant higher level of granularity with respect to calculating market risk capital requirements, are necessary to achieve safety and soundness for non-complex institutions with less than EUR 10 billion in assets given the relatively small—and similar—total amounts of capital assigned by either methodology for institutions of this size.

In addition, allowing non-complex institutions in the EUR 1 billion to EUR 10 billion asset range and with trading books up to 10 percent of risk-weighted assets to utilize the Simplified Alternative would help facilitate adoption of Basel III by reducing compliance burdens both on the institutions themselves under the Pillar 1 capital requirement calculations and on their regulators under the Pillar 2 supervisory review process.

Credit union regulatory agencies often have limited personnel resources, which can be an impediment to adoption of Basel III for smaller institutions due to Pillar 2’s burdens on the regulators, in addition to the impediments to Basel III adoption caused by compliance burdens on smaller institutions due to Pillar 1 calculations.

We urge the Committee to revise the threshold requirements for institutions eligible to utilize the Simplified Alternative to market risk to allow non-complex depository institutions with up to EUR 10 billion in assets and trading books up to 10 percent of risk-weighted assets to use this standard.

2. The Simplified Approach's Risk-Weights For General Interest Rate Risk, Equity Risk and Commodity Risk Should be Harmonized with the Standardised Approach

World Council urges the Committee to harmonize the Simplified Alternative's risk weightings for general interest rate risk, equity risk and commodity risk with those of the standardised approach to market risk. As proposed, the Simplified Alternative's risk-weighting for general interest rate risk is 5 percent instead of 1.5 to 2.4 percent under the standardised approach, and 10 percentage points higher for equity risk and commodity risk than under the standardised approach.[6]

We do not believe that the proposed higher risk weightings for the Simplified Alternative are justified on a safety and soundness basis because of the stringent proposed criteria regarding which institutions are eligible to utilize the Simplified Alternative at all. While trading less granularity for a higher market risk capital requirement seems logical with respect to complex trading books, we do not believe that this higher capital requirement would be justified with respect to non-complex depository institutions like credit unions that are subject to restrictive investment portfolio shaping rules.

Credit unions' exposures to equity risk would typically be limited to investments in the capital of wholesale credit unions that help facilitate payments, settlement and liquidity for retail-level credit unions (and these positions are often netted out from the retail-level institutions' capital) as well as investments in credit union service organizations such as payments service bureaus. Credit unions would only be likely to be exposed to commodity risk in the context of security for agricultural loans since few, if any, credit unions engage in trade finance or commodities trading.

In addition, we believe that trading less granularity for a higher capital requirement would not be consistent with the principle of proportionality for smaller, less complex institutions. Instead, if finalized as proposed, the Simplified Alternative would in effect trade one type of regulatory burden for another: Although an institution's compliance burdens associated with Pillar 1 calculations would be reduced, the same institution would be subject to a different regulatory burden in the form of higher (and therefore more expensive) reserve requirements.

We believe that harmonizing the Simplified Alternative's risk weights with those of the standardised approach would be more consistent with the principle of proportionality and would better facilitate adoption of Basel III by smaller, less complex institutions.

We urge the Committee to harmonize the Simplified Alternative's risk weightings for general interest rate risk, equity risk and commodity risk with those of the standardised approach to market risk.

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[6] *See* Basel Committee on Banking Supervisions, *Minimum capital requirements for market risk* (Jan. 2016), *available at* http://www.bis.org/bcbs/publ/d352.pdf.

3. **An Institution's Capital Adequacy Level is a More Appropriate Determinant of Creditworthiness than an "Investment Grade" Credit Rating for Non-Securitization Delta Credit Spread Risk**

World Council urges the Committee to revise its approach to Delta credit spread risk non-securitization exposures, such as investments in bank deposits, to include within the definition of "investment grade" well-capitalized depository institutions that have not been rated by a credit rating agency such as Fitch, Moody's or S&P. As proposed, non-securitization credit spread exposures to "investment grade" institutions would be weighted at 10 percent, whereas non-securitization exposures to "high-yield" and "non-rated" counterparties would be weighted at 25 percent.

We do not believe that there is a safety and soundness justification for equivocating exposures to well-capitalized credit unions, such as wholesale credit unions, with high-yield junk credit status simply because the credit union does not have a credit rating. Credit unions and many other smaller depository institutions typically do not have credit ratings because they do not issue debt securities. Credit rating agencies also performed poorly during the global financial crisis and the use of credit ratings for regulatory capital risk-weighting purposes is therefore disfavored or even unlawful in some jurisdictions, such as the United States of America under Section 939A of the Dodd-Frank Act.[7]

In addition, placing well-capitalized, smaller depository institutions in the same category as junk credit exposures would not be consistent with the principle of proportionality. As proposed, the standard would effectively require smaller institutions either to bear the expense of obtaining a credit rating solely because of Basel III market risk rules or be disadvantaged in its business by Basel III market risk rules because its counterparties would be required to hold higher reserves against that exposure compared to an exposure to a large bank whose cost of obtaining a credit rating is negligible relative to its annual revenue.

We believe that an institution's level of capitalization relative to its applicable capital requirements (e.g., a risk-based capital regime and/or or a leverage ratio), as disclosed under Pillar 3 of Basel III or similar disclosure requirements, is a more appropriate measure of a counterparty's financial strength for regulatory capital risk-weighting purposes.

In most cases credit rating agencies use an institution's compliance with Basel capital requirements as the main factor to gauge its creditworthiness; an institution's level of compliance with Basel III as shown in its Pillar 3 disclosure therefore provides much the same creditworthiness information as a credit rating without imposing the compliance costs associated with obtaining one. In addition, using the institution's capital adequacy under its applicable capital regime as the determinate of creditworthiness would be lawful in all jurisdictions, unlike credit ratings from potentially conflicted credit rating agencies.

We urge the Committee to revise its approach to Delta credit spread risk non-securitization exposures to include well-capitalized depository institutions that have not been rated by a credit rating agency within the definition of "investment grade."

[7] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, § 939A (July 21, 2010) (directing US financial regulators to remove credit ratings from their rules).

4. Equity Risk Definition of "Advanced Economies" Should Include the Republic of Korea and All European Union Member States

World Council urges the Committee to include the Republic of Korea and all European Union (EU) Member States within Paragraph 240's definition of "advanced economies" for equity risk purposes. As proposed, the equity-risk framework divides countries into only two categories: (a) "advanced economies;" and (b) "emerging markets," notwithstanding that the proposed "emerging markets" category includes a great diversity of economic development levels ranging from the least developed countries to EU-member non-eurozone central European economies to G20 economies such as the BRICS countries (Brazil, Russia, India, China and South Africa).

Proposed Paragraph 240's "advanced economies" are: "Canada, the United States, Mexico, the euro area, the non-euro area western European countries (the United Kingdom, Norway, Sweden, Denmark and Switzerland), Japan, Oceania (Australia and New Zealand), Singapore and Hong Kong SAR."

The Republic of Korea should be added to the list of "advanced economies" because it is defined as an "advanced economy" by the International Monetary Fund[8] and should therefore also be considered an "advanced economy" under Basel Committee standards as well. The Republic of Korea is also ranked eighteenth in the United Nations Human Development Index (one spot behind Japan and ahead of western European eurozone economies including Austria, Belgium, France, Greece, Italy, Luxembourg, Portugal, and Spain, as well as significantly ahead of Mexico, which is ranked 77th).[9]

The Republic of Korea is also currently issuing 10-year government debt with a coupon of 2.24 percent interest, which is broadly consistent with other proposed "advanced economies" such as Australia (2.62 percent), Canada (2.07 percent), Italy (2.09 percent), Singapore (2.01 percent), and the United States of America (2.17 percent), and at a far lower interest rate than the cost of borrowing by proposed "advanced economies" like Greece (5.47 percent) and Mexico (6.79 percent).[10]

Non-euro area EU Member States in central Europe, such as the Czech Republic or Poland, should be included as "advanced economies" for purposes of this standard as well because they are subject to the same EU financial regulatory and fiscal rules as other non-euro area EU Member States like Denmark and Sweden, because non-euro area central European economies are in many cases stronger than some eurozone economies such as Greece or Cyprus, and because all EU Member States should be treated equally in a neutral fashion for regulatory purposes.

In addition, since the Committee has proposed a binary system of "advanced economies" versus everything else, all EU-member economies are in a common market and are much

[8] *See, e.g.*, International Monetary Fund (IMF), *IMF Fiscal Monitor* at 104 (Apr. 2017), *available at* https://www.imf.org/en/Publications/FM/Issues/2017/04/06/fiscal-monitor-april-2017 ("Methodological and Statistical Appendix, Definition and Coverage of Fiscal Data, Table A; Economy Groupings").
[9] *See* United Nations Development Programme, *Human Development Reports*, Table 1: Human Development Index and its components (2016), *available at* http://hdr.undp.org/en/composite/HDI.
[10] *See* Economic and Financial Indicators, *The Economist* at 82 (Sep. 16-22, 2017).

more similar to one-another, in a binary framework, than they would be compared to the world's least developed countries. Non-euro area EU Member States also have more macroeconomic tools at their disposal than eurozone members for addressing future economic challenges. The increased macroeconomic flexibility of non-euro area EU Member States may help explain the much more robust economic recoveries from the global financial crisis for non-euro area EU members like the Czech Republic or Poland compared to some eurozone economies that continue to struggle nearly ten years after the crisis began.

We urge the Committee to include the Republic of Korea and all EU Member States within Paragraph 240's definition of "advanced economies" for equity risk purposes

5. Clarification Regarding Application of the Simplified Approach to the Trading Book

World Council urges the Committee to state clearly in the final version of this standard that the Simplified Alternative is limited in application to the trading book and does not apply to hold-to-maturity investments in the banking book, as is the case with the standardised approach to market risk.[11] We believe that this clarification, including a footnote to the Basel definition of the trading book,[12] will help improve users' understanding of the standard and reduce potential confusion, especially considering that the Committee is proposing the Simplified Alternative to try to facilitate adoption of Basel III by institutions that may not currently be familiar with the Committee's standardised approach to market risk.

World Council appreciates the opportunity to comment on the Basel Committee's consultative document *Simplified alternative to the standardised approach to market risk capital requirements*. 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

[11] *See* Basel Committee on Banking Supervisions, *Minimum capital requirements for market risk* at 5-9 (Jan. 2016), *available at* http://www.bis.org/bcbs/publ/d352.pdf.
[12] *Id.*