TALKING POINT

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Capital Punishment

Banks and market organisations are poring over the Basel Committee on Banking Supervision's Consultative Document, '*Reducing variation in credit risk-weighted assets — constraints on the use of internal model approaches*', which is due for comment by 24th June 2016. For Commodity Finance banks, it doesn't make good reading.

The Basel premise is to mistrust low default portfolios and to then attempt to lump them into a one-size-fits-all Standardised or IRB Supervisory Slotting Approach, 'to restrict the use of internal models' in calculating regulatory capital for credit risk. Their concerns are that 'it is difficult for banks to obtain reliable estimates of PD for low-default exposures' and that there's a 'notable dispersion in the levels of estimated risk, as expressed in the probability of default (PD) and loss given default (LGD), that banks assigned to the same exposures'. But this is surely no surprise! Commodity Finance is specialised lending and can only be as good as its incumbent specialists: some will have a broad depth of experience and be demanding in how risk is managed, whilst others may be more liberal. It's even debatable whether it's institutions who carry the experience or the individuals who populate them? One thing seems inevitable though, that resorting to the insufficiently risk-sensitive Standardised Approach will drop standards to the lowest denominator, taking away the competitive advantage of those who have invested in highly skilled specialists, relevant IRB risk models and dedicated transaction management teams. It even threatens to dismantle the infrastructures that have enabled Commodity Finance to maintain its low loss legacy to date.

Is this an unintended consequence? The gap between an unsecured LGD and that enabled for a secured LGD under the Standardised Approach is getting so marginal that if banks can't translate the investment in dedicated risk managers and transaction management teams into an underlying capital benefit, they will simply start to dis-invest, encouraging a return to clean, unmonitored lending, if any at all. This surely runs counter to the improved risk management landscape that Basel seeks to achieve?

What the BCBS seems to have totally ignored is HOW the Commodity Finance community has achieved its low loss legacy, where recent default data points to a 0.21% average loss rate on EAD for Commodity Finance (*source: AFME Consultation Response 27th March 2015*). Until the BCBS gets round the table with practitioners to understand fully the drivers of a [genuine] low loss experience, it will continue to be seen as punishing the market on capital treatment. The CF community doesn't want favourable treatment; it simply wants fair and equitable treatment.

BCBS seems to suggest that the CF community has come too late in the day to effect any changes… but having largely ignored CF under prior Basel incarnations, and now causing it notable impact by current proposals, the BCBS will be doing effective regulation a disservice if it now penalises good practice for the paucity of its defaults.

"The BCBS's second proposal for the revised Standardised Approach puts a 120% risk weight on Commodity Finance, whereas aggregated historical data collected among active commodity lenders leads to implied RWAs lower than 50%."

- AFME Consultation Response, 27th March 2015

BCBS Proposals

- Removal of own estimates of collateral haircuts
- Removal of double default
- Maturity to be fixed 2.5yrs for F-IRB
- Unconditionally cancellable to be captured under 'commitment'
- Use of supervisory CCFs