21 June 2016

Basel Committee on Banking Supervision
Attention: Banking Committee Secretariat
Bank for International Settlements
CH-40002 Basel Switzerland

Re: Comment letter on the consultative document: reducing variation in credit risk weighted assets – constraints on the use of internal model approaches, issued March 2016

Basel Committee Secretariat,

This comment letter on the above-referenced consultative document (the '**Consultative Document**') is submitted by the Aviation Working Group (see www.awg.aero, '**AWG**'). AWG is a non-profit group comprised of major banking and other financial institutions and manufacturers from around the world, and works on regulations and practices to facilitate international aviation financing and leasing. Its members are from Brazil, Canada, China, France, Germany, Japan, Singapore, the United Arab Emirates, the United Kingdom, and the United States. AWG has status at, and other working arrangements with, several international and intergovernmental organisations, including the OECD (where it works on international export credit financing rules), UNIDROIT (where it was central to the development of an international treaty on security over aircraft collateral and now works on that treaty's global implementation), and ICAO (the UN body for international civil aviation, where it works on a range of projects).

AWG comments on the proposals in the Consultative Document, with references to paragraphs and defined terms taken from the Consultative Document. In particular, these comments focus on paragraph 2.1 (summary of proposals) of the Consultative Document which proposes the removal of IRB approaches for *inter alia* specialised lending and large and medium sized corporates (the '**Proposals**').

<u>executive summary</u>

1. The Proposals would fundamentally and adversely change the regulatory framework applicable to capital requirements for credit risk, lack justification, and require major modification.

2. The foregoing conclusion is driven by the following points, which, taken together and elaborated on below, summarise our comments:

2.1 Further deliberation on, and data relating to, the Proposals are required, given their unjustified and substantial adverse effects.

2.2 The Proposals should enhance, not restrict, risk sensitivity, meaning that (i) the IRB approach should be retained, with no floors, and (ii) the standardised approach ('**SA**') should be made more risk sensitive.

2.3 The Proposals would produce misalignment between (i) internal risk assessment and capital requirements, and, more generally (ii) internal risk and the regulatory-produced cost of capital. The Proposals are not justified on grounds of risk.

2.4 Nor are they justified on economic and policy grounds, as they would have a range of substantial adverse effects, including on (i) the economy as a whole, in general, and the aviation sector, in particular, and (ii) the intended regulatory objectives of the Basel Committee.

<u>need for modified process</u>

3. The sophisticated IRB approach for specialised lending and lending to large and medium sized corporates has been developed, tested, and refined over many years. Any fundamental change to that approach requires deliberation and data commensurate with its wide-ranging implications. That is magnified given the blunter nature of the proposed alternatives, being the SA or a constrained IRB approach with unjustified high LGD floors and/or the slotting approach for specialised lending. Further deliberation and data are required.

4. Such additional deliberation and data should take into account the need to align with the parallel and related initiatives on the assessment and effects of internal models, including those of the European Banking Authority (regulatory technical standards) and the European Central Bank (proposed a target review of internal models), each of which seeking conformity with the Proposals. The timing of the final Proposals should be aligned with these initiatives.

<u>need for greater risk sensitivity</u>

5. The Proposals would remove well-developed metrics that more accurately determine risk in specialised lending and lending to large and medium sized corporates than what they contemplate. There is a need for *greater risk sensitivity, not less*. This should be achieved through (i) greater harmonisation and transparency with respect to different bank's IRB methodologies, rather than disapplying IRB approaches, and (ii) modifying the SA to reflect more risk sensitivity, which, correspondingly and beneficially, would enhance alignment with the IRB approach. On the former, performance model-oriented parameters should be developed over the coming period. On the latter, such could be achieved through (a) somewhat more granularity in use of external rating (e.g., the differentiation between higher and lower investment grades), (b) lower risk weightings for shorter term transactions than longer term transactions, and (c) lower risk weighting for senior and/or secured exposures.

<u>need to retain the IRB approach - for specialised lending and large- and medium-sized corporates (focus on aviation object finance)</u>

6. The Consultative Document notes that banks are 'unlikely to have sufficient data to produce reliable estimates of PD and LGD' with respect to specialised lending and large corporates, and, in consequence, that the SA, the Slotting Approach or floors must be employed in such transactions. That is not the case. Such data-based estimates exist and indicate that: (i) re PDs, financings, including of corporates, secured by aircraft collateral have low default levels (indicating low risk levels - yet it is proposed that banks be penalised for this low risk), and (ii) re LGDs, such financings have high recovery rates, and, in particular, that actual LGDs are a fraction of (a) the implied risk weighting of 120% that would apply using the SA, and (b) the proposed IRB floors that would apply in the limited continued use of internal models for asset-backed financings. More generally,

large banks have sophisticated and well-developed IRB models which, while centred on PDs and LGDs, include additional (risk-refining) metrics – for example, externally assessed asset values performed throughout the transaction by third party specialist used in determining these items. Their IRB models are regularly tested both internally and externally (including by regulators), resulting in sensitive and refined risk modelling. Moreover, penalising transactions for which default rates are low raises basic policy concerns.

7. The principal reason for low risk and loss levels in aircraft-backed financings is transactional structuring based on reliable collateral and strong legal rights relating thereto. Aircraft financing is structured to ensure control over cash flows from the underlying assets, a comprehensive security package, and prudent LTVs based on stable asset values. The adoption of the Cape Town Convention by jurisdictions around the world provides a more uniform and predicable legal mechanic to enforce against secured assets. Once security is enforced, banks have access to a large and liquid global secondary market for aircraft assets, thus maximising the realisation of value. The removal of the IRB approaches does not give credit to the low risk and loss levels in aircraft-backed transactions.

8. The resulting application of the SA produces substantially higher capital requirements, and a mismatch between risk and regulatory-required capital. There are also technical problems and inconsistencies in the SA, which should be addressed to effect greater risk sensitivity within the SA and alignment between the SA and IRB approaches. These include the treatment of lending to parts of large corporate groups supported by the credit of the overall group.

<u>adverse consequences of the proposals</u>

9. The Proposals will have a number of material adverse consequences, including (i) a substantial increase in regulatory capital, despite assertions of capital neutrality, (ii) the misalignment between risk and the regulatory-produced cost of capital, (iii) the reduction of incentives to reduce risk (and potential incentives to lend on an unsecured basis), contrary to the core policies of the Basel Committee, (iv) discrepancies in RWA measurement, resulting in additional RWA variations, contrary to the core policies of the Basel Committee, (v) harm to the economy as a whole, and (vi) harm to aviation lending and the air transport sector, on account of specialised lending becoming economically less attractive.

10. As regards such harm to aviation lending[1] and the air transport sector, reference is made to our letter to the Basel Committee dated 10 March 2016, which *inter alia* notes the anticipated increase (in customary aircraft-backed financings to special purpose entities) in capital by 200% - 300% compared with current experience-based IRB practices. This would unjustifiably and fundamentally disrupt the specialised lending market, which is crucial for a stable and sustainable economy, investment in safe and environmentally-

[1] Approximately USD 120 Billion of financing was required to support Airbus and Boeing deliveries in 2015. Financing levels for such Airbus and Boeing deliveries are expected to increase to USD 170 Billion per year by the end of the decade. These levels increase further when the deliveries of other manufacturers are included. A substantial part of such financing requirements are met through bank lending.

friendly advanced aircraft, the growth of needed air transport capacity, and increased transportation-related trade, with its large multiplying effects.

<u>recommendation action</u>

11. AWG recommends (i) further deliberation on, and testing the validity of data relating to, the Proposals, (ii) modification of the Proposals to retain the IRB approaches with no floors for specialised lending and lending to large and –medium sized corporates, (iii) harmonising aspects of technical modelling (parameters, not output) to enhance comparability of models, and (iv) revisions to the SA to increase its risk sensitivity. These items require increased engagement between regulators and financial institutions to ensure better transparency and harmonisation of the metrics used to determine RWAs within different institutions' IRB approaches (and for the SA approach). This would help meet the stated policy objectives of Basel Committee (in particular, limiting variability and enhancing comparability) without removing the well-developed methodologies that allow risk to be accurately assessed in aviation lending.

<u>Next steps</u>

AWG requests a meeting with the Basel Committee to elaborate on, and provide substantiating data in respect of, these comments, and to plan further work to assist the Committee.

Sincerely yours,

Claude Brandes
Airbus
Co-Chairman, Aviation Working Group

Daniel Da Silva
Boeing
Co-Chairman, Aviation Working Group

CC: Jeffrey Wool, secretary general, Aviation Working Group