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World Council Comments on Revisions to Standardized Approach to Credit Risk

World Council of Credit Unions (World Council) filed a comment letter on March 27th in response to the Basel Committee on Banking Supervision's consultative document *Revisions to the Standardized Approach for Credit Risk.* The Basel Committee is the primary international standard-setting body for banking institution safety and soundness rules. Our comment letter expressed concern about aspects of the Committee's proposal that would be incompatible with how many credit unions underwrite mortgage loans and could also make it difficult for credit unions to borrow in the interbank lending market.

Regarding mortgages, our comments did not support the Basel Committee's proposal to use mortgage borrowers' "debt service coverage" (DSC) ratio—a ratio that indicates what portion of a person's gross monthly income goes toward paying debts, and is also known as the "back-end ratio"—as a risk-weighting element for mortgages in jurisdictions that do not commonly use the DSC ratio in mortgage underwriting. Although most credit unions in Canada and the United States use the DSC ratio in mortgage underwriting, credit unions in other jurisdictions, including Australia and many European countries, instead underwrite mortgages based on the borrower's net income after expenses. We urged the Basel Committee to establish an alternative system for risk-weighting mortgages that is compatible with how credit unions currently underwrite mortgages in jurisdictions that do not commonly use the DSC ratio, like Australia and Europe.

We also expressed concern about the Committee's proposed method for gauging the riskiness of interbank loans to financial institutions that are not subject to Basel III-style risk-based capital rules. Globally, most credit unions are not subject to Basel III.

Basel III's proposed new approach to risk-weighting interbank loans would be based on the borrowing institution's ratio of "Common Equity Tier 1 Capital" (which includes retained earnings) to "risk-weighted assets;" interbank loans to institutions that could provide this ratio would be risk-weighted as low as 30 percent of the loan's face value. Interbank loans to non-Basel III institutions, however, would be risk-weighted at 300 percent of face value.

As proposed, a Basel III-compliant bank would therefore be required to hold reserves against loans to non-Basel III institutions which would be up to 10 times greater than the reserves it would hold against loans to Basel III-compliant institutions. These new reserve requirements would likely result in non-Basel III credit unions being shut out of the interbank lending market, or only being able to obtain interbank loans at very high interest rates, unless they chose to adopt Basel III de facto when they otherwise would not be required to.

We urged the Basel Committee to use the borrowing institution's leverage ratio of capital to total assets—instead of its ratio of Common Equity Tier 1 Capital to risk-weighted assets—for purposes of risk-weighting interbank loans because the leverage ratio is a sound indicator of a financial institution's health whether or not it is subject to Basel III.

Financial Action Task Force and AML/CFT Customer "De-Risking"

On March 26-27th the Financial Action Task Force—the global standard setting body for Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT) rules—held a consultative forum with the private sector in Brussels, Belgium. World Council represented the global credit union movement at this meeting where the discussion focused on the phenomenon of financial institutions "De-Risking" their

customer bases by ceasing to do business with customers who present higher AML/CFT risks and compliance costs.

Our comments to the FATF focused on how De-Risking can impact credit unions both in their roles as financial service providers and also when they are customers of banks. We explained how credit unions can face regulatory pressures not to have money services businesses (MSBs) or similar financial businesses as members because of these types of members' perceived higher AML/CFT risks, but also explained how credit unions can have trouble opening and maintaining correspondent bank accounts because of De-Risking by banks. We urged the FATF to issue guidance that would help reduce De-Risking by clarifying financial institutions' AML/CFT compliance responsibilities with respect to MSBs and other financial institutions, including in the correspondent banking context.

The FATF will likely issue a guidance paper on MSBs' AML/CFT risks later this year that should clarify credit unions' AML/CFT compliance responsibilities with respect to MSBs. The FATF is also considering developing a separate guidance paper on De-Risking in general that could help address credit unions' concerns about access to correspondent banking services; whether or not the FATF will move forward on this additional De-Risking guidance project will likely be decided at the FATF's June 21-26th plenary meeting in Brisbane, Australia.

Financial Stability Board Total Loss-Absorbing Capacity Proposal

World Council filed a comment letter on February 2nd in response to the Financial Stability Board's (FSB) consultation on the *Adequacy of loss-Absorbing Capacity of global systemically important banks (G-SIBs) in resolution*. The FSB is responsible for promoting global financial stability by coordinating the development of financial sector policies, especially with respect to G-SIBs. Although no credit unions are G-SIBs, credit union regulators sometimes apply rules intended for G-SIBs to large credit unions under the theory that the large credit unions are systemically important to the credit union system or to the applicable savings guarantee fund.

The FSB proposal would require G-SIBs to hold "total loss absorbing capacity" (TLAC)—composed of retained earnings, equity instruments, and debt instruments that can be converted to equity in the event of losses—in an amount equal to 16-20% of the institution's Basel III risk-weighted assets. G-SIBs would be required to issue a minimum amount of convertible debt instruments to outside investors to meet their TLAC requirement; in the event of losses, the TLAC debt instruments would convert to common stock in the bank at a strike price significantly lower than the debt instrument's face value (such as common stock equal to 30 percent of the debt instrument's face value).

These TLAC debt instruments would therefore create a type of "bail-in" mechanism where, in order to recapitalize an institution that had suffered substantial losses, its TLAC debt instrument holders would bear these losses in exchange for common stock representing a significant ownership interest in the recapitalized institution.

We urged the FSB not to create rules that could be interpreted as requiring credit unions to issue convertible debt instruments to non-member investors because it would be difficult to reconcile this requirement with credit unions' member-owned cooperative structure. We also urged the FSB to allow institutions to count uninsured deposits towards their TLAC requirements since uninsured deposits can also absorb losses in a failure and are more easily compatible with the credit union model.

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