

Rabobank
Executive Board



Rabobank

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Secretariat of the Basel Committee on Banking
Supervision
Bank for International Settlements
Centralbahnplatz 2, CH-4002 Basel,
Switzerland

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Enclosures 1

Subject Rabobank response to the BCBS consultation imposing constraints on the use of internal risk models

Dear Mr Coen,

Rabobank welcomes the opportunity to respond to the “Reducing variation in credit risk weighted assets – constraints on the use of internal model approaches” Basel consultation document. In the first part of our response we focus on the potential far reaching impact on agri lending. In the second part we discuss the main other impacts of the proposals and the improvements that are needed in our view. Our response supplements the responses given by the Dutch Banking Association, European Banking Federation, European Association of Co-operative Banks, IIF and AFME/GFMA. Rabobank also has submitted data to national supervisory authority DNB and to BCBS for Quantitative Impact Studies, so that decisions on the proposals can be taken on the basis of more data. In the annex we have added the response by our Rabobank Agri Finance subsidiary, which is based in the US.

Rabobank's key message

Rabobank warns that the new Basel proposals for advanced bank credit models could result in highly undesirable and unforeseen effects on agri financing. The proposals – if adopted unchanged – will result in much greater capital reserves than the customary reserves currently held in the market and will greatly exceed the reserves needed to absorb the actual losses on the agri portfolios. The rules would also impact loans to major businesses, financial institutions, specialised lending, goods financing and leasing. Rabobank considers the rules to be disproportionate to the intended objective and instead would like to draw attention to the importance of the further improvement of the internal models, including the adoption of more stringent criteria. The combined impact of proposals of the latest consultation paper with the new SA proposals published in December 2015 will in addition seriously impact the mortgage portfolios¹, for which capital reservations are very much based on the value of collateral and low probabilities of defaults.

¹ Please note that the impact of new (draft) capital rules for *mortgage portfolios* was already raised in the response letters of banking associations for revised SA and Floors consultations. We kindly refer to these responses. In this letter we focus on the impact of IRB constraints.

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Discussion of the impact of proposals on agri lending

Agri financing is characterised by strong collateral and customisation, with the use of risk mitigation structures. The collateral consists of the farmland, machinery or for example the market value of the agrarian produce. This provides a lot of security for the bank and decreases the risk the bank takes on the loan. We believe that these aspects are not sufficiently taken into consideration in the proposals. They would penalize these well-collateralised exposures and would lead to increased costs for agri finance. Furthermore, the credit quality of the portfolio is significantly better than the quality of non-agri portfolios.

To further substantiate our point, we provide an example for Food and Agri in the Netherlands. The write offs and the provisioning in the agri sector in the last 10 years are approx. 50% less than in the non-agri sector. Similar results have been experienced in the US (see Annex). We also expect that the write offs and provisions for the agri sector in other parts of the world are relatively lower compared to non-agri sectors.

In our view, the best thing to do is to continue to use internal models *without* imposing floors. Banks with sufficient loss data on the businesses in their portfolios - in the case of agri financing data for at least a full 7 year agri-cycle - should be allowed to use their internal models for those portfolios in such a way that all relevant data can be used. The leverage ratio already acts as a back stop to determine the minimum required level of capital for a bank.

Only if the BCBS committee deems the floors to be indispensable, we argue that at least different floors should be applied for agri, as for other corporate assets or real estate assets. Even though part of the financing risks are similar, the key characteristics, the risks and consequently the loss data for banks are different. The collaterals and the recuperation rates of loans are simply not the same in the agri sector as compared to the non-agri sector. The internal models account for these differences by using a sector specific agri indicators; indiscriminate floors do not.

Pursuant to already existing conditions, the internal models are subject to reviews by the banks and supervisory authorities. Capital adjustments are being made when loss data or specific observations about the model give cause to do so. The Rabobank reviews its models regularly and is in contact with the relevant supervisors about the continuous enhancement of models. The floors proposal is in this regard not helpful and as it intervenes in a very generic way in this process it would produce some very unexpected and counterintuitive results. This will be clearly harmful for the business, for banking and the economy.

Discussion of the main other impacts of the proposals

Introduction

The 2016 BCBS proposals lead to significant capital increases for the Dutch banking sector, concludes the Dutch Banking Association, based on an analysis of data from the largest Dutch banks.² We can confirm these potential impacts for our bank. Based on feedback we received from the European Banking Federation we believe that the level of required capital will increase for many other European banking sectors as well. At the same time it has been stated by the GHOS that overall the total capital level in the banking system should remain the same. We believe that this can only be accomplished by a substantial change of the current proposals or in any case a very careful calibration, taking account of the characteristics of different markets segments.

Besides agri lending the current proposals would cause significant capital increases for Specialised Lending (object and commodity finance, project finance - including infrastructural project financing, and international trade financing), lending to Large Corporates, Leasing, SME lending, Lending to Banks and Income Producing Real Estate. The main reasons are the unfavourable treatment of collateral in a system of floors and the fact that risk mitigation techniques and specific knowledge of risks (e.g. project finance) are not rewarded with a lower capital requirement.

This is clearly bad news for risk sensitivity, which in our view would have a negative impact on financial system stability. We expect adverse risk selection and competition based on regulatory arbitrage. If markets acknowledge that the risk of an activity or asset is in practice indeed lower than the capital rules would treat it on a bank balance sheet, these activities will most probably shift elsewhere. For activities or assets carrying a higher risk, but categorized within the same risk category, the opposite will hold. This further illustrates that instead the use of IRB models should be enhanced.

IRB models

Since inception in 2007 the advanced models have improved performance increasingly and the industry has taken several steps to further improve the credit models in the past years. The availability of data has also increased substantially. In our view the investment banks have undertaken in models is a corner stone in setting capital standards for the future.

We are open to good initiatives to improve criteria for models, to simplify them where possible and to make models more transparent. IIF for example made some good suggestions in their response paper. Rabobank is member of IIF and we have participated in their research on this topic. We expect beneficial results from increased benchmarking. We also believe that improvements can still be made within the internal models by scrutinizing the assumptions in models and harmonising the definitions that are used. We are generally positive about the

² See The Dutch banking sector (NVB) response to the consultation. Rabobank endorses this response and has submitted data for the analysis of impacts by the NVB.

approach the European Banking Authority has adopted to the enhancement of the quality of the banks' internal models.

We believe that in case sufficient data are available, A-IRB models should remain to be preferred, instead of denying their use for certain exposure classes (or subset thereof). Although the A-IRB is the preferred credit risk framework, we agree that further improvements to the A-IRB framework are required further reducing the unintended risk weight variation. We also suggest keeping exposures to banks and larger corporates on A-IRB if the data to build robust internal models meets certain minimum requirements.

Capital floors

A Capital Floor does not improve the overall capital framework; as it will weaken the link between risk profile and capital by overwriting the A-IRB framework. An output floor is clearly not needed either, next to the Leverage Ratio and on top of the IRB revisions to the capital framework. The capital increasing impact, even calibrated at 60% of the revised SA, would be very significant for Dutch banks. More specifically, we would like to highlight the case of mortgages. Loss given default data on mortgages – at least in our jurisdiction - do not justify applying an output floor for such portfolios. The defaults in the Netherlands are very low compared to other countries, even at the height of the economic crisis they did not increase very much in absolute terms. The number of foreclosures is equally low. At the same time LTV's are high and tax deductibility has contributed to that. In the next years the tax deductibility will diminish, and paying into a mortgage is incentivised, lowering LTV's. Nonetheless, there is a 'paradox' with low PD's and LGD's and still high LTV's. This has very much to do with the institutional setting of the Dutch market: an elaborate pension system; a system of job protection and unemployment benefits; a strong legal position for lenders; a credit history check and affordability check for those applying for a new mortgage; and the National Mortgage Guarantee Scheme. In report 'The Dutch Mortgage Market' (NVB, 26 may 2014) this is explained in detail. It illustrates that not all markets can be compared easily. The mortgage markets in other EU markets do not have the same characteristics, determining risk.

Conclusion

Rabobank is of the opinion that the current proposals for the amendment of the rules governing internal models are disproportionate to the intended purpose. These will actually have an ineffective and contrary effect on risk sensitivity and the appropriate real-risk-based differentiation of capital requirements. Rabobank is concerned about the detrimental effect on the role banks play in financing the economy and about the regional and global level playing field between the various financing providers. Rabobank, as one of the world's largest F&A banks, requests that explicit attention be given to the potential impact of the proposals on the financing of agricultural businesses. The agri sector, which is of importance to the economy of the European Union, the Member States and the development of rural areas, is now at risk of being confronted with an abrupt amendment of the rules governing risk models. Furthermore corporate lending, SME lending and Specialized Lending and mortgages (in combination with

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Our reference

impact of output floors) would be strongly affected. We do not think such action is justifiable by the facts, as we demonstrated in the different responses where we have participated.

We are willing to further discuss these issues and to examine alternatives that can increase the stability of the financial sector, improve transparency and possibly reduce the complexity of modelling of risks.

With kind regards,



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June 24, 2016

Dear Sir/Madam:

Re: Rabo AgriFinance ("RAF"), a United States based lending institution with affiliation with the larger global Rabobank Group, response to the BCBS consultation on internal models.

RAF sincerely appreciates the opportunity to provide comments on the BCBS's consultative document, ***Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches*** ("consultative document"). We would first like to endorse the Committee's mission of promoting monetary and financial stability, and likewise applaud the act as a forum for discussion and cooperation amongst the financial community in matters such as this. We respectfully opine as follows;

Considerations

We highlight the importance of evaluating all of the many proposed regulatory changes holistically to ensure that the Committee's objective of not significantly increasing overall capital requirements is met. RAF is solely focused on serving and lending to the Food and Agricultural lending space. As we find often with regulatory guidance, both locally and globally, agriculture is typically not expressed separately, but rather in conjunction with all banking and lending activities. This presents many challenges in our industry.

With regard to the consultative document, this response focuses on Section 3 and the proposed parameter floors for Corporates, more specifically the LGD floors. Section 3 describes floors for Real Estate as "Commercial or Residential Real Estate", with a proposal of 15% and floors for other physical collateral with a proposal of 20%. We feel strongly that the proposed floors are unsound for agri business as it does not factor in or distinguish performance of agricultural based collateral. RAF does not lend in "residential", and the term "commercial" is viewed as too broad to capture the remaining types of real estate. Commercial real estate is typically viewed as real estate such as

hospitals, doctors' offices, business offices, warehouses, retail stores, etc. Agricultural land and agricultural-use facilities do not fit into this "commercial" category. Agricultural land is highly sought after land and strictly used for production of agricultural commodities/food related products. With a growing global population, many publications cite research that call for the need to improve productivity to feed mankind in the future. Obviously, the globe only has so much land available for production farming activities.

So in summary, the need for, and use of agricultural land will not waiver, and even through the 2008 financial crisis, losses in the agricultural segment were not as steep as those experienced in other non-agricultural sectors. We believe other agricultural-based lending institutions would have similar views and experiences.

Agricultural lending is, by and large, secured lending with agricultural land/buildings and crops/seed/agricultural chemicals as collateral. The security is perfected via mortgage (on farm land/buildings) or a pledge (on crops/seeds/agricultural chemicals). The underwriting criteria are more conservative than applied in commercial/residential real estate financing (approximately 50% - 70% maximum Loan to Value for farmland, more conservative than commercial/residential real estate. Residential real estate upwards of 95% Loan to Value). The agricultural portfolios have historically performed very well compared to non-agricultural portfolios. As alluded to above, even during the financial crisis around the time of 2008, agricultural lending generally continued to prosper. For example, according to FDIC data for all FDIC based institutions, loans secured by agricultural land real estate showed a net-charge off rate of 0.03% to 0.55% from Q1 2008 - Q4 2009. In the same time span, commercial and industrial real estate for U.S. addresses showed a net charge-off rate of 0.83% to 2.98%, dramatically more severe than agricultural land loans.

The likely reason for the strong performance is that in a worst case liquidation scenario, agricultural land/buildings as well as crops/seed/agricultural chemicals, are sold with relative ease (often to a neighbour farm) and due to the need to keep farmland in production as previously mentioned. International and local governments tend to support their agricultural sector. For instance in the U.S., crop insurance is managed and backed by the government, which provides on-going support for both revenue and weather related control. Further, the agricultural sector is already benefitting from attractive financing offered by the Farm Credit System (funded by the US Treasury) and insurance companies which are very competitive in long term farmland collateral-based financing.

Conclusion

RAF believes that setting parameter floors is unacceptable and disregards the extensive work and effort that the industry has invested in establishing modelling practices and governance processes that ensure the models perform well in managing risk. In the U.S., modelling regulations such as SR11-7 have aided this effort. Further, the parameter floors are categorically too broad and severely impact those lending in the agricultural space.

Instead of setting floors, the existing established modelling practices and standards should be continued, or perhaps even established further, and coupled with institutions that have sufficient and reliable default data, those institutions should be able to determine their own floor based on

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several years of history (at least 5-7, which generally coincides with agricultural sector cycles) and continue with the foundation brought forth in risk sensitivity under IRB.

There have been significant investments in developing risk sensitive models and rating systems. These have been fully integrated into overall risk management processes. This has allowed for improved risk assessment and capital determination that is commensurate with risk. We feel the proposed would lend itself toward a movement away from these positive investments.

We thank you for taking our comments into consideration, and we look forward to future discussions on these issues.

Respectfully,

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