



COMMENTS FROM THE ASSOCIATION OF SUPERVISORS OF BANKS OF THE AMERICAS (ASBA) TO THE CONSULTATIVE DOCUMENT

“Second Consultative Document: Revisions to the Standardized Approach for Credit Risk”

*(ISSUED BY THE BASEL COMMITTEE ON BANKING SUPERVISION FOR COMMENTS BY
11 March 2016)*

I. Purpose of the revision

In its first consultative document, the Basel Committee proposed the removal of credit rating agencies to reduce mechanistic reliance on them and proposed a set of risk weights based on two risk drivers. However, industry members expressed concerns about the removal of credit rating agencies, the complexity of estimating drivers; and the potential for the proposal to be insensitive to risk. Thus, the current proposal reintroduces the use of external credit ratings to determine risk weights for various exposures.

To complete the revision to the standardized approach for credit risk, this consultative document focuses on exposures to banks and corporates; subordinated debt; equity and other capital instruments; retail portfolio, residential and commercial real estate; as well as land acquisition; development and construction; add-ons for currency mismatches; off-balance sheet exposures; exposures to Multilateral Development Banks (MDBs); defaulted exposures and; the credit risk mitigation framework (CRM).

Thus, recognizing the limitations of the original approach, in removing all references to external ratings, the Committee proposes to reintroduce external ratings in a non-mechanistic manner and subject to due diligence requirements for the above-stated exposures. Also, alternative approaches are proposed for jurisdictions that do not allow the use of external ratings for regulatory purposes.

As in the first consultative document, this revised proposal seeks to achieve a balance between simplicity and risk sensitivity and enhance comparability by reducing variability in risk-weighted assets across banks and jurisdictions. In its final version, the standardized approach (SA) is expected to become a suitable alternative and a complement to the Internal Ratings-Based (IRB) approach.

Following are the comments made by the members of the Association of Supervisors of Banks of the Americas (ASBA) that we submit for your consideration.

II. General Comments

1. The Association shares the view that the most important aspect of dealing with risk-weighted assets and the corresponding capital charges is the effectiveness of risk management and that; as such, ratings provided by Credit Rating Agencies constitute a reference. Consequently, the Association understands that a rating is a reference for setting risk-weights to particular exposures.
2. The Association considers the estimated capital charges a minimum requirement. Thus, it understands that supervisors may require a more conservative treatment if they consider it



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necessary to meet special or local needs under the understanding that the proposal constitutes a minimum requirement and not a substitute for prudential risk management.

3. To contribute to market discipline, the Association is of the opinion that banks should publicly disclose information about their credit assessment approach, thus reducing discrepancies when comparing capital requirements.

The above mentioned might present challenges to supervisors conducting examinations at the time of validating and comparing prudential information. At the same time, the proposal may require entities to provide more detailed information regarding their credit portfolios, which could lead to the need to revise information systems.

4. The Association recommends supporting the use of International Financial Reporting Standards, to evaluate effectively assets, provisions, and capital charges. The adoption of the Standards would enhance both disclosure requirements and the expected comparability.
5. The Association recommends an ongoing analysis between the currently used external credit rating approaches and the new approach to assessing their impact on capital requirements and making sure the latter remains as prudent as the former approach.
6. Authorities should be more proactive with rating agencies when analyzing, validating, or gaining a minimum knowledge about rating methodologies used, including their disclosure regimes. Thus, ratings and methodologies shall not be taken in an automatic or mechanical manner.

III. Specific Comments

1. Exposure to Banks, Risk Weight Floor (Page 6; Paragraph 4)

The Committee agrees that “Where external ratings are available and used, these risks would be assessed as part of the overall rating assignment by the credit rating agencies. Where external ratings are not available or used, however, the Committee is of the view that this may be reflected by incorporating country ratings (e.g. OECD country ratings) as an objective criterion for each grade bucket, or by imposing a risk weight floor based on the risk weight applied to the sovereign exposures (as a proxy)”.¹

The Association would agree with this requirement, provided that it does not include the obligation of using a jurisdictions’ sovereign rating in domestic transactions; thus, allowing weight floors lower than 100%.

The Association supports the use of the OECD sovereign ratings as risk weight floors for bank exposures in jurisdictions that do not apply ratings.

¹ Basel Committee on Banking Supervision. Revisions to the Standardised Approach for credit risk. Second Consultative Document. December 2015.



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2. Subordinated Debt, Equity and Other Capital Instruments (Page 9; Paragraphs 8-9)

As for subordinated debt, equity, and other capital instruments, the Committee proposes differentiated risk weights: a 250% risk weight for equity holdings that are not deducted or, a 150% risk weight for subordinated debt and capital instruments other than equities.

The Association suggests assigning a flat 250% risk weight to subordinated debt, equity, and other equity instruments, due to their risk similarities.

3. Other Off-balance Sheet Items (Page 15; Paragraphs 8-9)

The current treatment, as well as the first revision of the SA for credit risk, proposed that for commitments that are not unconditionally cancellable, a 75% CCF (Credit Conversion Factor) regardless of their maturity should be applied. However, this second revision proposes applying a 20% for commitments up to one year and a 50% for commitments above one year.

In this respect, the Association recommends the adoption of the current criteria (same as the first revision), which is more in line with the IRB approach; preferably, without distinguishing between retail and wholesale exposures. Thus, the proposal is to apply a flat 75%, which seems to be a more prudent approach.²

4. Regulatory Retail Exposures (Page 10; Paragraphs 4 and 5)

As per Regulatory Retail Exposures, the proposal states that for all retail exposures that meet the criteria listed, a 75% risk weight would apply.

The Association proposes that the available income of the borrower should be considered an additional criteria to determine Regulatory Retail Exposures.

5. Real Estate Exposure Class (Page 34; Paragraphs 3 through 8)

Under the real estate exposure class (residential or commercial), the following requirements to apply risk weights are proposed: finished property; legal enforceability; claims over the property; the ability of the borrower to repay; the prudent value of the property; and the required documentation.

Regarding the above:

² The Committee even notes in this consultative document that: “...empirical evidence from several data collections, including the QIS and the data collection carried out by the Committee in 2014 to examine the variability in the calculation of banking book risk-weighted assets, does not support the application of differing CCFs based on maturity. Moreover, data substantiates an increased CCF for these types of off-balance sheet exposures, consistent with the foundation IRB approach. Preliminary analysis suggests that, for general commitment as well as NIFs and RUFs, the appropriate CCF should be in the range between 50% and 75%. Further analysis will follow in the second QIS.”



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- I) There is a need to clarify whether such requirements shall be considered only at origination or if banks are going to be constantly reviewing the use of the property to determine whether the repayments are dependent on cash flows.
- II) Additionally, under the real estate exposure class, the corresponding risk-weights are provided in the tables included. As a matter of complimentary criteria, the time to maturity of the loan should also be included.

6. Risk Weight Add-on for Exposures with Currency Mismatch (Page 14; Paragraphs 8 to 10)

The Association supports an add-on risk weight to exposures with currency mismatches. However, perhaps a differentiation could be made between retail and corporate exposures. Provided that corporations may have access to hedging, a risk weight on the net unhedged position seems more adequate.

7. Defaulted Exposures: Risk Weight Treatment (Page 17; Paragraph 5)

The second revision proposes the removal of the current treatment that allows for a lower risk weight of 100% where a past due loan is fully secured by forms of collateral that are not eligible under the CRM (Credit Risk Management) framework.

Although the proposed framework seems to be appropriate, the region could have entities holding ineligible collateral for some types of exposures. Thus, in some constituencies, the Association warns that the removal of this concession could result in higher capital charges.

8. Other Issues

The document states that the 0% risk weight for core market participants shall be reviewed, given that it is inconsistent with the treatment of short-term wholesale funding set out in the liquidity standards and considering the role of short-term wholesale funding had during the financial crisis.

The 0% risk weight should be applied only to core market participants who have not been downgraded at any time, to improve risk sensitivity. Also, a 0% risk weight could apply to highly rated collateral instruments.