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Bank for International Settlements
Centralbahnplatz 2
4051 Basel
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Dear Sir/Madam,

Basel Committee on Banking Supervision: Consultative Document: Standards: *Revisions to the Standardised Approach for credit risk*

The Australian Bankers' Association (**ABA**) on behalf of its members appreciates the opportunity to comment on the Consultative Document (**CD**): *Revisions to the Standardised Approach for credit risk.*

The ABA is broadly supportive of the objective to review the standardised credit risk approach, namely to increase simplicity, comparability and risk sensitivity in capital requirements. However, the proposed two-factor approach, despite having more data points, may not in fact achieve the goal of being more risk sensitive, and may produce risk-weighted assets that give the illusion of comparability, while actually introducing distortions when compared to the true underlying risk.

The ABA is also concerned that the proposals seek to deliver a one size fits all approach, which does not recognise robust prudential and market overlays in different jurisdictions. The proposals as they stand will penalise those jurisdictions with robust regulatory regimes and benefit those jurisdictions with weaker prudential structures; the proposals offer no incentive to address these weaknesses.

Relative to the internal ratings-based (**IRB**) approach, the proposed standardised approach fails to appropriately reflect the difference in risk management capability, and importantly the structural differences between jurisdictions (such as legal frameworks, market conditions, accounting approaches full recourse loans, etc.). As such, some national discretion should be available to reflect these jurisdictional differences.

In terms of impact, our members are indicating that on initial assessment the proposals are likely to represent a potentially significant increase in capital under the proposed calibration, which combined with a floor requirement, could become the binding constraint by which banks would manage risk and price their products. This would interfere with one incentive to use and develop the IRB approach for risk information, risk management and governance.

Whether these limitations of the standardised approach ultimately impact IRB banks is also highly dependent on the calibration of any capital floor. As a number of important risk factors are ignored under the proposed standardised approach in combination with a capital floor, the gap between actual risk and the risk implied by the capital requirements widens. In addition to the economic inefficiencies this creates, it may result in damaging incentives for banks. For example banks may be encouraged to reduce exposure to low risk portfolios (such as low risk banks and corporates whom typically have higher leverage), and increase exposure to higher risk counterparties. As the gap widens this also encourages a greater shift on credit provision from the regulated to unregulated shadow banking sectors.

Timeframe

The ABA notes that the Basel Committee has just embarked on a thorough revision of the prudential standards for capital requirements. The ABA understands that the Committee seeks to finalise its proposals for a revised approach to credit risk within twelve months. The ABA firmly believes this is far too short a time frame for such a wide ranging revision. The ABA would also support a further quantitative impact study (**QIS**) on a second round of refined proposals that further considers consultative feedback and the current QIS for calibration.

The ABA also believes that the capital floor proposals under concurrent consultation cannot be considered separately from the design and calibration of standardised approaches or the further review of IRB approaches the Committee is undertaking. The ABA is of the opinion that any new scheme for capital floors should only be devised, as a final step, over a stable and internally consistent prudential framework.

In seeking to enhance the current standardised approach for credit risk, the Committee has identified a number of weaknesses that the proposals aim to address, these are:

- over-reliance on external credit ratings;
- lack of granularity and risk sensitivity;
- out-of-date calibrations;
- lack of comparability and misalignment of treatment with exposures risk-weighted under the IRB approach; and
- excessive complexity and lack of clarity within the standards.

The ABA supports the Committee's objective of seeking to promote simplicity, comparability and risk sensitivity. There are however, aspects of the proposed framework which conflict with these principles. There are four areas in particular that we wish to highlight:

- the reduced reliance on external ratings;
- the need for comparability adjustments for different accounting and legal practices across jurisdictions;
- disclosure; and
- timing of implementation.

External credit ratings have a role

In its current form, the ABA has serious concerns that the proposed revision of the standardised approach would result in a less reliable measure of risk as it is not clear that there are benefits from entirely moving away from the use of external credit ratings.

While the ABA understands the objective of reducing reliance on external credit ratings, it should only be done in a way that measures risk as well. It is simply not clear that any 2 driver metric approach can adequately replace the deep and valuable datasets on which an external credit rating is based.

External credit ratings utilise a broader range of metrics than simple financial ratios to determine the risk profile of an entity and provide a level of risk standardisation across different industries and jurisdictions. Replacing external credit ratings with a limited number of risk drivers also introduces a number of challenges, in terms of:

- greater complexity in implementation and disclosure;
- comparability issues across jurisdictions; and
- maintaining risk sensitivity across different industries and entity types.

The criticism of external credit ratings has largely centred on the performance of structured product credit ratings, and conflicts of interest that rating agencies face when rating these products. The ABA notes rating agencies have made significant changes to address this; specifically, Standard & Poor's updated their bank rating methodology in 2011 and Moody's has just released their updated methodology. It should also be noted that credit rating agencies have undergone significant business model changes of their own accord, and major jurisdictions have implemented licensing regimes to address reliability and confidence in ratings.

There are other drawbacks of moving to simple metrics which are not addressed in the CD. Removing external credit ratings reduces risk sensitivity in two ways. Firstly, point-in-time estimates are more detailed and based on better information than two balance sheet estimates and secondly through-time ratings are far more dynamic and reflective of changes in risk. Currently, risk ratings often move well ahead of balance sheet deterioration, or even in the absence of any discernible balance sheet change.

The ABA supports the continued use of external credit ratings in conjunction with other risk drivers in the framework; with additional focus on the ongoing improvements to rating agency methodologies where it can be demonstrated that deficiencies remain.

Comparability and national discretions

The proposed standardised approach fails to appropriately reflect the structural differences between jurisdictions (such as legal framework/enforceability, accounting definitions, tax regimes, economic maturity levels competitive environments or market maturity).

Certain appropriate comparability adjustments can provide a level of standardisation and comparability in a global framework. As a simple example, full recourse exposure in one jurisdiction vs non-recourse in another, can distort risk metrics and their comparability, particularly when measured using simple financial ratios. We believe comparability adjustments are necessary within the framework.

As such, certain national discretions are recommended to reflect these jurisdictional differences, together with clear definitional guidance for consistency of application.

Disclosure

As a general rule the standardised approach is designed to provide consistency in interpretation and approach to methodology and therefore the measurement of risk-weighted assets. This objective of the proposals cannot be achieved without all jurisdictions using exactly the same capital, accounting and factor definitions. The ABA notes that disclosures will need to take into account some national discretions.

Consistency in definition is also necessary for Pillar 3 disclosures; it is not clear that adding greater variability of interpretation of the standardised approaches supports those principles behind Pillar 3 reporting.

Before responding in detail to the Committee's specific questions the ABA wishes to provide some high level messages on the proposals contained within the CD.

Mortgage exposures

The current proposals on the treatment of mortgage exposures are of significant concern. The proposals do not cater for jurisdictional differences and the benefits of specific market and prudential overlays in certain jurisdictions. The calibration of the mortgage risk-weights will be critical in determining capital ratios for mortgage exposures in all jurisdictions. We urge the Committee to continue engagement with the banking industry and other interested stakeholders after considering the comments received and the results of the QIS in order to refine the approach.

Corporate exposures

The ABA has significant concerns that the proposed methodology is too simplistic to accurately capture risk across a diverse range of corporates in different industries and jurisdictions. The lack of variation in the calibration across industries is particularly problematic, as both revenue and leverage will naturally vary across different industries without necessarily reflecting differences in credit risk.

Bank exposures

As noted by the Committee, the use of risk-based capital adequacy measures can lead to counterintuitive results, for example, if banks are required to hold additional Pillar 2 capital they would receive a lower risk-weight. Beyond this, using Basel III ratios has a potential to lead to higher risk-weights for Australian banks because of the more conservative application of the Basel framework in Australia.

Notwithstanding our concerns on the proposals as they currently stand, the ABA welcomes this opportunity to respond to the questions posed in the CD.

Q1. What are respondents' views on the selection of the capital adequacy ratio? In particular, is the CET1 ratio superior to the Tier 1 ratio or the Leverage ratio? Do respondents agree that it is necessary to require calculations in accordance with Basel III in order to ensure a consistent implementation?

Of the various measures of capital (CET1, T1, Total Capital, Leverage), the ABA believes CET1 is the most appropriate. Leverage in particular, should not be considered given the lack of risk sensitivity.

However, capital ratios represent only one of the various inputs that determine a bank's credit risk, noting that capital ratios are an output of that risk under the risk-based capital framework. Capital ratios do not capture risks that are addressed through Pillar 2 capital requirements and each regulator's approach to setting minimum capital requirements differs, meaning two banks in different jurisdictions can have identical capital ratios, despite having very different risk profiles relative to their capital levels.

The ABA continues to support the inclusion of external credit ratings given they are a far more timely and holistic view of a bank's risk profile.

The ABA also strongly supports that if used, any measure of risk-based capital ratios should be based on comparable ratios that incorporate variances to both the Basel minimums and 'internationally harmonised' jurisdictional implementation.

Q2. Do respondents believe the net NPA ratio is an effective measure for distinguishing a bank exposure's credit risk? What alternative asset quality measure, if any, should be considered by the Committee?

The CD suggests two possible measures for assigning risk-weights to bank exposures: the Common Equity Tier 1 (**CET1**) ratio and the net non-performing assets (**NPA**) ratio.

The CET1 ratio is a misleading measure of risk. Relatively low credit quality banks may require higher CET1 ratios to compensate for these weaknesses. In fact many sub-investment grade banks have equal or higher CET1 ratios than AA rated banks.

As stated earlier, the use of risk-based capital adequacy measures can lead to counterintuitive results, for example where banks are required to hold additional Pillar 2 capital they would receive a lower risk-weight. Beyond this, using Basel III ratios has a potential to lead to higher risk-weights for Australian banks because of the more conservative application of the Basel framework in Australia. To avoid this, any measure of risk-based capital ratios should be based on comparable ratios that incorporate variances to both the Basel minimums and an 'internationally harmonised' jurisdictional implementation.

There is also concern that measures based on accounting information may not be a comparable measure across banks. Ratings methodologies strive for comparability across institutions, which is more difficult to achieve for individual banks' accounting practices.

The net NPA ratio could be an effective measure for distinguishing a bank's exposure credit risk. However, the net NPA ratio will suffer from procyclicality. External credit ratings are designed to be "through the cycle", so in the ABA's view is a more effective measure of risk for use in determining capital requirements. There are also a number of other considerations to ensure comparability and risk sensitivity, for example:

- A clear definition of the terms "non-performing loan" and "loss" etc, needs to be articulated and applied consistently across counterparties and accounting standards. For example, the treatment of hardship cases across banks and jurisdictions.
- Identifying the provisions associated with each class of asset may not be easily attainable.
- Asset quality assessment needs to consider off-balance sheet items.
- NPA also ignores credit risk in the trading book and is less likely to be a meaningful differentiator between commercial banks and investment banks.
- When it comes to assessing whether or not a counterparty's NPA ratio is "good or bad", banks often take into account the jurisdiction of the counterparty.
- A NPA ratio on its own does not indicate that the counterparty's management is successful in managing its risk exposure. Counterparties can reduce NPAs if need be and they will appear to have good asset quality.
- The implementation of clear default definitions would be required to provide for inter and intra-regional comparability, as the non-performing asset definition varies across jurisdictions which provides for low predictability of this ratio across jurisdictions.

Q3. Do respondents have views on the proposed treatment for short-term interbank claims?

It is important to have the preferential treatment of short-term interbank claims. A set proportional reduction seems like a reasonable approach that balances simplicity and risk sensitivity. It is difficult to say at this stage whether 20% is the correct calibration, but the 30% floor is punitive relative to the current standardised treatment where short-term claims to banks rated BBB- or better are risk-weighted at 20%.

Q4. Do respondents have suggestions on how to address these concerns on the treatment of exposures to banks? In particular, do respondents have views on how to treat exposures to banks not subject to Basel III in a consistent and risk-sensitive manner?

Determining the risk-weight of banks using two ratios is too simplistic to cater for the size and range of banks across jurisdictions. While we understand the Committee's concern, the ABA recommends the use of external credit ratings, and where possible, strengthening the use of risk drivers, including in instances where a bank is not subject to Basel III.

Q5. Do respondents have views on the selection of risk drivers and their definition, in particular as regards leverage and the incorporation of off-balance sheet exposures within the ratio? Would other risk drivers better reflect the credit risk of corporate exposures?

The ABA has significant concerns that the proposed methodology is too simplistic to accurately capture risk across a diverse range of corporates in different industries and jurisdictions. The lack of variation in the calibration across industries is particularly problematic, as both revenue and leverage will naturally vary across different industries without necessarily reflecting differences in credit risk (these variations are taken into account by ratings agencies via differentiated industry rating methodologies). The suggested use of year-end audited financial results will also mean that the data is not available in a timely manner. In addition it needs to be recognised that a significant number of corporate exposures to small-to-medium enterprises (**SME**) are not audited.

The proposed risk drivers could also have unintended consequences for risk in a financial system. For example, using revenue as a factor could encourage concentrated exposures to larger counterparties, rather than diversified exposures. Revenue is also volatile, increasing the procyclicality of capital requirements.

The proposed approach may also encourage risky lending behaviour, by favouring lending to high risk customers and industries that happen to have relatively low leverage. There are often valid reasons why a customer has low leverage, for example, sufficiently high risk characteristics have made borrowing difficult. A further weakness in the proposal is the lack of recognition of both security and tenor. These are considered critical inputs in evaluating the risk of an exposure.

SME business lending is disadvantaged by the proposed approach, discouraging lending to this particular segment could have a significant negative impact on economic growth. Lack of reliable financial data for the SME segment potentially provides for excessively punitive outcomes.

These limitations in the proposed risk drivers suggest that a very complex set of measures would be needed to adequately replace the information provided in external credit ratings. In the ABA's view, it would be preferable to maintain a system that compliments the deep and valuable datasets used in the production of external credit ratings. The ABA also supports using security as a factor to graduate risk-weighting.

Particular concerns are:

- Leverage, as highlighted by the Committee, is not a comparable indicator of risk across industries and jurisdiction. The leverage of industries such as mining services or fashion retailers is in no way comparable to a diversified corporate.
- A leverage based on accounting standards for the relevant jurisdiction is not comparable and will lead to anomalies in credit assessment between banks and intra banks where banks operate across multiple jurisdictions. Entities with the same capital structure, but in a different jurisdiction will potentially have a different risk rating.

- There is insufficient granularity in the threshold levels, an exposure with 20% gearing (TL/TTA) sits in the same band as an exposure with 67% gearing.
- If large firms are deemed to be less risky than small firms, revenue may be artificially inflated to achieve a different status and more favourable treatment by a bank. This may result in a borrower taking on counterparty risk to enter into sale and repurchase contracts.
- Like leverage, revenue is not comparable across industries. Trading companies have high levels of revenue but that does not correlate to low risk.
- Incorporation of off-balance sheet exposures, whilst valuable from a credit assessment perspective, adds significant complexity for smaller exposures. Significant policy, procedure and system changes would be required to incorporate off-balance sheet exposures. Results may vary markedly unless there is a very prescriptive methodology for factoring in off-balance sheet commitments.
- The Committee should also consider the inclusion of the benefit for taking non-real estate security.
- Interest coverage ratio (ICR) calculated using either earnings before interest, taxes, depreciation and amortization (EBITDA) or earnings before interest and tax (EBIT), is another metric that may be considered in tandem with leverage to better determine the risk profile of an entity. ICR is a key metric that is likely to be used in most expert models

Q6. Do respondents have views on the appropriateness of the proposed treatment, especially with regard to SMEs? And about the more lenient treatment for start-up companies?

In the ABA's view it seems counter-intuitive that a start-up would receive more lenient treatment under this regime, particularly given the risk of start-ups is higher in their first two years of operation. In addition, the treatment of corporates with outdated financials seems overly punitive under the new proposals with the assumption of a maximum risk-weighting. The term for financials to be made available should be extended to 18 months to allow for the maximum full year of operation and the subsequent reporting period.

Q7. Do respondents think that the risk sensitivity of the proposal can be further increased without introducing excessive complexity?

Continued use of external credit ratings would improve risk sensitivity and provide a simple framework that is well understood by investors.

The ABA considers that the external ratings-based approach should be maintained as with the *Exposure to Banks* in *Section 2.1*. Principally this is due to the diverse range of industries that are captured within the definition of corporate exposures, including insurance companies, finance companies and security firms which will typically have materially different balance sheet structures to manufacturing or retail corporates.

It is recognised however that a larger proportion of corporate exposure is not rated by external ratings agencies and a mechanism for risk sensitivity is required for these entities which would complement a ratings-based approach. The inclusion of a more granular industry table within the corporate segment, and keeping with appropriate risk drivers, would be appropriate without being overly complex.

Greater risk sensitivity

Concerns remain over the insufficient level of granularity and underlying risk measures. It is expected the QIS will provide evidentiary support for calibrations, however, where the Committee has used data in support of the current proposal, it would be useful to have this made available to understand proposed calibration.

There are also concerns as to the lack of recognition of tenor and security. Globally, all banks place significant weight on the tenor and security/collateral features of lending when evaluating the risk (and subsequent pricing) of the facility. A concern with the standardised proposals is the lack of recognition of these important factors across most of the asset classes.

Q8. Do respondents agree that introducing the specialised lending category enhances the risk sensitivity of the standardised approach and its alignment with IRB?

The ABA is supportive of the proposal to align the specialised lending approach to that adopted by IRB banks. This will clearly provide more risk sensitivity than including all exposure under the corporate asset category and a greater level of comparability with approved IRB banks.

However, if a standardised lending category is introduced it should be identical to that applicable to the IRB approach. The currently proposed approach which applies the maximum of the applicable corporate risk-weight or the specialised lending risk-weight is likely to be very punitive with high risk-weights applying due to the level of leverage in most specialised lending categories.

In Australia, national discretions have been applied which do not recognise the "commercial real estate" or "Regulatory Retail" (which includes small business) categories. The introduction of specialised lending without a revision to that decision would magnify the potential adverse impact.

The introduction of a specialised lending category will however, increase the complexity of risk assessment for standardised banks and will impact their capital and system requirements. Standardised banks or portfolios currently hold more capital across all transactions than IRB banks and the need for greater complexity for what the Committee concedes is a small part of a standardised banks business, may not be the best use of resources to attempt to implement this approach. Revised proposals should establish minimum exposure size to which the specialised lending category would apply.

Risk-weightings for subordinated or any lower ranking exposure should be risk-based and relative to the risk-weight applicable to senior debt.

Q9. Can respondents suggest, and provide evidence on, how to increase the risk sensitivity of the regulatory retail exposures treatment, either by differentiating certain product subcategories for which a specific risk weight may be appropriate; or by suggesting simple risk drivers that could be used to assess the risk of all retail exposures?

The Committee should consider applying risk-weights lower than 75% to retail loan products that are collateralised, for example, auto loans and leases. Equally, the risk sensitivity of regulatory retail exposures treatment would be enhanced through inclusion of key risk drivers in determining risk-weights.

For example, the following key risk drivers have been consistently seen in the Australian and global retail portfolio modelling, although many will be cyclical in nature:

- customer relationships with the bank e.g. time as customer;
- lending servicing ability e.g. disposable income, income to loan ratio;
- lending type e.g. product type (personal loan vs. credit card), lending amount, secured vs. unsecured lending, refinance, insured vs. non-insured loans, recourse v non-recourse;
- customer demographics e.g. age, number of borrowers, occupation, occupancy detail;
- customer wealth e.g. assets values, share values, savings balances;
- account usage e.g. limit usage, arrears, paid ahead of schedule (prepayments);
- willingness to pay e.g. loan to value ratio, use for day to day living expenses vs. luxury items, guarantor.

As an example, products within an Australian banks' IRB framework is a relatively effective discriminator of risk. Credit cards in general carry a risk-weight which is double that of residential mortgages and in comparison, personal loans have a risk-weight five times that of residential mortgages. Using benchmarks from IRB banks may be a method of increasing the risk sensitivity of the standardised framework.

The Committee should consider the higher risk elements of retail exposures treated on a standardised basis such as:

- Differing risk assessments of interest only loans relative to principal and interest and Line of Credit style loans.
- Assessment of payments in advance as a measure of risk for pooled products.
- A significant gap exists between regulatory retail (including retail SME) and corporate risk-weighting, providing potential for a "cliff effect" in risk-weighting. This is not evidenced in the IRB approach where corporate (particularly secured corporate) risk-weightings are not as punitive as proposed.

Q10. Do respondents agree that LTV and/or DSC ratios (as defined in Annex 1 paragraphs 40 and 41) have sufficient predicative power of loan default and/or loss incurred for exposures secured on residential real estate?

The ABA supports the use of loan-to-value (**LTV**) but does not support the proposed use of the debt service coverage (**DSC**) ratios in assigning risk-weights as this measure is difficult to define and not considered a reliable indicator of relative risk.

While LTV and DSC have been shown to have some explanatory power in predicting losses on mortgage exposures, they are too blunt to be used to determine capital ratios for mortgage exposures in all jurisdictions.

Any measures should be applicable over the life of the loan and simple to assess. Origination of LTV and DSC are not predictive over the life of the loan/capital horizon and normally only used in the application assessment phase which usually covers the first 6 months of the loan. The ABA supports the comment in the CD related to "the difficulty in obtaining updated borrower income information once a loan has been funded" and therefore concurs that collecting this information on an ongoing basis would not be feasible.

For exposure secured by residential real estate the use of a LTV ratio is appropriate. The LTV has historically been a reasonable predictor for mortgage credit risk. However, it should be noted that LVR is only one of many characteristics that may be used to determine a customer's ability to pay. Jurisdiction and legal differences can also impact on how LTV influences mortgage credit risk e.g. losses will vary by LTV if on a recourse or non-recourse basis.

Consideration should be given to the misconception that all high LTV customers (i.e. 90%+ LVR) are at high risk. There are customers with high LTVs who have excellent balance sheet positions with a proven track record of credit history. In Australia, this is influenced by the fact that customers need to provide evidence of genuine savings, and require a strong application score to have the loan approved at this level. A typical "low risk" and "high LTV" customer might exhibit some of the following characteristics:

- a healthy savings balance (which indicates effective management of wealth);
- a high level of disposable income/low DSC;
- low debt to equity ratio;
- good performance on existing products; and
- clean credit bureau file.

Buffers on income, tax rates, tax incentives and frameworks bespoke to countries can also impact the presentation of what is a "net income". Other information that may significantly enhance the risk sensitivity are documentation type, balance as a ratio of original loan amount, a self-employed flag, LMI, owner occupied vs. investment, interest only loan, customer asset to liability ratio and bureau information.

Q11. Do respondents have views about the measurement of the LTV and DSC ratios? (In particular, as regards keeping the value of the property constant as measured at origination in the calculation of the LTV ratio; and not updating the DSC ratio over time.)

The ABA supports the proposal to hold the value of the property constant, but does not support the use of DSC ratios as proposed.

As accounts age over time both the LTV and DSC ratios at origination will become less meaningful, and may only be applicable for relatively new loans as it is not always practical to regularly update property values and in particular, borrowers income details. Regularly updated LTV and DSC ratios would also contain considerable variability depending upon the point in the application cycle.

The treatment of investor loans where no income is recognised from property and only borrower's personal income used in DSC, is very punitive. Investor loans would have to be treated as retail loans with a risk-weight of 100%. Given the growth in investor loans this would have a significant impact on aggregate RWA between the current and proposed versions.

In Australia, we have developed a serviceability ratio framework based on significant experience and deep data. This serviceability ratio differs to the proposed DSC ratio. While consistency in the application of standards is important for improving the comparability of capital ratios across jurisdictions, there should be clear evidence that the benefits will outweigh the costs of aligning different national practices. If not, consideration should be given to national discretions to calibrate the serviceability to local practices (to achieve an equivalent end result).

In addition, by proposing a single threshold for the DSC ratio under which exposures would receive preferential risk-weights, the proposal could encourage clustering of exposures just under the threshold. A more granular approach would be more risk sensitive and would reduce this incentive to cluster exposures, without a significant increase in complexity.

Q12. Do respondents have views on whether the use of a fixed threshold for the DSC ratio is an appropriate way for differentiating risk and ensuring comparability across jurisdictions? If not, what reasonably simple alternatives or modifications would respondents propose while maintaining consistent outcomes?

The ABA does not consider the DSC to be a useful measure for understanding the risk characteristics of a residential real estate portfolio. There are concerns around the use of a fixed threshold of 35% and consistency in the assessment of income, particularly for "self-employed" customers, given the jurisdictional implications of various methods for assessing net income and different tax rules. Further clarification is requested from the Committee around the treatment of investment lending position as rental income derived from the property collateral is currently recommended not to be recognised in the net income calculation (whilst tax on rental income would be included in the net income calculations).

Q13. Do respondents propose any alternative/additional risk drivers for the Committee's consideration in order to improve the risk sensitivity in this approach without unduly increasing complexity?

The ABA recommends that after reviewing the QIS responses the Committee give further consideration to the different prudential and market overlays and the positive impacts these additional overlays have. As an example, a number of Australian banks, via the ABA, have committed to the gathering and collation of data of their mortgage books and sharing this with the Australian Prudential Regulation Authority (**APRA**). This is intended to demonstrate the positive impacts the additional overlays such as Lenders Mortgage Insurance (**LMI**) have and how they can be used in the quantification of risk.

The ABA recommends consideration be given to the inclusion of three additional factors that have an important influence on expected losses. The first is whether the mortgage exposure has appropriate insurance that protects the lender from losses in the event that the borrower defaults - LMI is prevalent in both Australia and Canada. The second factor is whether the borrower's income has been verified when calculating affordability. Loans with stated income, or where affordability has not been properly assessed, have performed more poorly over the global financial crisis. Including this factor would help ensure that banks' loan approval processes are robust. Both of these proposed additional factors are currently part of APRA's standardised approach for determining standardised risk-weights for Australian banks' mortgage exposures (see table below).

Table: APRA's framework for standardised mortgage risk-weights

LVR (%)	Standard eligible mortgages		Non-standard eligible mortgages	
	Risk-weight (no mortgage insurance) %	Risk-weight (with at least 40% of the mortgage insured by an acceptable LMI) %	Risk-weight (no mortgage insurance) %	Risk-weight (with at least 40% of the mortgage insured by an acceptable LMI) %
0 – 60	35	35	50	35
60.01 – 80	35	35	75	50
80.01 – 90	50	35	100	75
90.01 – 100	75	50	100	75
> 100.01	100	75	100	100

Finally, whether a loan is full recourse or non-recourse has a significant influence over the experienced losses. In general full recourse loans have lower losses than non-recourse loans, and this should be reflected in the risk-weights.

The ABA strongly supports the ability for local regulators to include some additional local requirements that may be appropriate in periods of increased risk or market developments. The use of these macro prudential tools can be refined based on jurisdictional nuances and factors. The decision by Sweden to apply higher risk-weights via Pillar 2 in response to concerns about elevated risk in the housing market is one way of pursuing this. A slotting approach based on agreed structural indicators of high or low risk is another way of increasing the risk sensitivity of the standardised approach.

Q14. Which of the two options above is viewed as the most suitable for determining the risk-weight treatment for exposures secured on commercial real estate?

It is the ABA's view that Option A and Option B are not adequately calibrated. In particular, Option B fails to recognise risk mitigation from a security perspective by assigning risk-weights which are unduly punitive. Our recommendation is for the Committee to review the risk-weights proposed within Option B, and consider the inclusion of security.

The collateral value should be the basis for which risk-weights are assigned and therefore our view is that Option B is preferable. Additionally, volatility in property value (and therefore LGD) could be addressed via clear articulation of valuation requirements (timing and robustness) therefore an LTV based approach would seem more appropriate.

Ignoring collateral is counter-intuitive when the Committee recognises in other parts of the CD that it provides a protection against losses. The non-recognition of collateral would adversely impact the capital treatment of well secured exposures given no benefit is assigned to security under the current punitive proposal for corporates and specialised lending.

Q15. What other options might prudently increase the risk sensitivity of the commercial real estate treatment without unduly increasing complexity?

The risk sensitivity of the commercial real estate treatment could be enhanced without unduly increasing complexity by broadening the criteria beyond LTV. Currently, the proposed treatment is one-dimensional based on LTV, which is largely a measure of loss after default. Introducing variables that predict the default risk of the client such as use of external ratings (where applicable), and income ratios (e.g. EBIT, net profit after tax (**NPAT**), quality and reliability of cash flow) would allow for greater risk sensitivity.

On the options to prudently increase the risk sensitivity of commercial real estate, the ABA would suggest more allowance for the value of collateral along the lines of the table in paragraph 38, page 36 of the CD. In the Basel corporate segment, residential and commercial real estate is only a second way out and the punitive capital weights proposed ignore the value of collateral and the lack of losses of the magnitude implied in the table presented in paragraph 46, page 38.

Q16. Do respondents agree that a risk-weight add-on should be applied to only retail exposures and exposures secured by residential real estate? What are other options for addressing this risk in a simple manner?

The ABA agrees that some form of a risk-weight add-on should be applied to retail exposures and exposures secured by residential real estate where there is a currency mismatch between the currency of the loan and the borrower's income.

Q17. Do respondents consider the categories for which a CCF is applied under the standardised approach to be adequately defined?

The ABA believes that banks should continue to apply a 0% CCF where that bank is able to actively manage counterparties who may be experiencing difficulties by reducing their limit. The ABA would also continue to supports a 0% CCF for industry support arrangements that are approved by the local regulator. In regards to short term claims (less than 1 year), the move from maturity based CCF to a flat 75% CCF is punitive and lacks risk sensitivity.

Q18. Do respondents agree that instruments allocated to each of the CCF categories share a similar probability of being drawn and that the probabilities implied by the CCFs are accurate? Please provide empirical support for your response.

The introduction of a 10% CCF for cancellable commitments will have a material impact on some banks. This change may also require consideration to be given to the calculation of exposure for the purpose of prudential reporting of large exposures.

The increase to 10% from 0% CCF for unconditionally cancellable commitments is not supported. For Australia, this is mainly credit cards which are unconditionally cancellable and do not meet the view of the Committee that consumers can challenge the cancellation. Consideration could be given to whether they are truly unconditionally cancellable. Where they are not (due to legal, internal or reputational consideration) then application of a maturity based CCF is more appropriate.

Q19. What are respondents' views on the alternative treatments currently envisaged for past-due loans?

Risk-weights for past-due claims should be an add-on to the risk-weight applicable to the exposure if it was not classified as past-due. Any increase in risk-weight should be offset by the amount of any provision taken on the exposure. The Committee should ensure that there is consistency in the default/delinquency definition including for example, the treatment of "hardship" arrangements.

Q20. Do respondents agree with the proposed treatment for MDBs?

The proposed treatment is appropriate and provides clarification if the change to bank asset classification alters from a ratings-based approach to risk drivers

Q21. What exposures would be classified under "Other assets"? Is a 100% risk-weight appropriate? (Please provide evidence where possible).

The general position of all other assets and claims not specified elsewhere would be risk-weighted at 100%, is reasonable. However, the Committee has not covered:

- Direct holding of cash and gold held by a bank; these should continue to receive a zero risk-weight; and
- Cash in the process of collection; this is currently risk-weighted at 20% and appears reasonable.

Q22. What are respondents' views on the above alternative ways to define eligible financial collateral?

The question is focussed on what appropriate debt securities (provided they are investment grade) can be held as financial collateral. While it is not mentioned, the ABA is assuming cash is acceptable.

Given our previous comments that banks should use external credit ratings if available, we find the proposal to use simple measures to determine if a security is “investment grade” to be vague. Use of investment grade potentially increases complexity or jurisdictional variability.

The ABA would recommend two different approaches to determine financial securities ratings, if an external rating is not available. These ratings could then be used to determine the mapping into a supervisory haircut look-up tables, for example:

- For IRB banks - using the standardised approach to determine the floor, they should be able to use their own internal ratings to determine the haircuts to the supervisory haircut look-up table; and
- For standardised banks - they could use an acceptable credit spread index approach to map financial securities into the supervisory haircut look-up table. This approach would require supervisory approval of credit spread providers, which may be difficult given the lack of trust in external rating agencies.

Q23. What are respondents' views on the recalibrated supervisory haircuts shown in Table 4? What are respondents' views on how to eliminate references to ratings from the supervisory haircuts table? What could be the implications of eliminating references to external ratings?

To date, Australian banks have designed their systems to be aligned to a ratings-based approach; therefore continued use of external ratings is supported. As previously commented, the analysis undertaken by rating agencies are more robust and detailed than simple financial ratios. In principle, the proposed table of haircuts is workable; however, due to the issues identified with respect to having an external credit ratings-based approach, the same difficulties will ultimately arise here. The ABA therefore does not support the proposed table.

The table aligns with risk-weightings proposed within the CD. Given the ABA has highlighted significant concerns on the approach and calibration of proposed risk-weights; this should also be reflected in the proposed haircuts.

Q24. What are respondents' views on the proposed corporate guarantor eligibility criteria?

Further clarification is needed on how the Committee currently defines "economic relationship" when considering the relationship between the borrower and the corporate guarantor. It is an unnecessary burden on banks to establish the commercial or economic relationship where one did not previously exist for the borrower and corporate guarantor. The key determinant for guarantor eligibility should be based on the absence of any economic relationship or interdependence between the borrower and guarantor and if there is true economic benefit expected from the guarantee. Thus, eligible guarantors should not be limited to non-corporates.

The ABA would also like to express our support for the submissions of the International Banking Federation and the Institute of International Finance, as we are broadly aligned as an industry with the key messages expressed in their feedback.

We thank you for taking our comments into consideration and would be pleased to discuss them further at your convenience. The impact of the reforms will vary greatly depending on the final calibration, given this the ABA would support a further QIS and another opportunity to respond to a second round of refined proposals once the committee has had time to consider the responses received to this consultation.

Yours sincerely,

Aidan O'Shaughnessy