

24 June 2016

Secretariat of the Basel Committee
on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland
baselcommittee@bis.org

Doc Ref: #183060v2
Your ref:
Direct ☎: +27 11 645-6708
E-✉: garyh@banking.org.za

Dear Sir/Madam

Response on the Basel Committee on Banking Supervision's Consultative Document: "*Reducing variation in credit RWA assets – constraints on the use of internal model approaches.*"

We thank you for the opportunity to comment on the Basel Committee on Banking Supervision's (BCBS) consultative document, *Reducing variation in credit RWA assets – constraints on the use of internal model approaches* (consultative document). Our response paper is divided into 2 sections, General comments & Specific comments (Annexure A)

General comment

We concur with the overall concerns expressed by the Institute of International Finance (IIF) and International Banking Federation (IBFed) that the reduction in risk sensitivity may have unintended consequences.

In this letter, we add our concern that the proposed constraints will have localised impacts that were not explicitly highlighted by these international entities.

It is important to take into consideration that the proposed methodology may lead to unintended behavioural changes which is not the intention of the framework.

We would also like to underline the importance of ensuring consistency between the accounting and prudential frameworks in the light of the latest accounting norms.

We thank you in advance for your consideration of our comments, and we would be pleased to discuss our submission at your convenience.

Yours sincerely



G Haylett
Prudential Division

ANNEXURE A**Comments on the Reducing Variation in Credit RWA – constraints on the use of internal model approaches – 24 June 2016**

Reference to paper	Comments
Output Floors	
To replace the Basel I floor, one option the Committee is considering is whether to have an aggregate output floor which could be calibrated in the range of 60% to 90%. An alternative could be to apply output floors at a more granular level, where appropriate. The final design and calibration will be informed by a comprehensive quantitative impact study and by the Committee's aim to not significantly increase overall capital requirements	•We caution against strict capital floor levels because these floor levels will be a disincentive for banks to invest in continuously trying to measuring their risk profile better •Emphasis should be placed on ensuring that the framework remains risk-sensitive and that capital floors are not a disincentive to hold larger lower risk assets. •A capital floor above 60% in our view will result in a reduction in the risk sensitivity that is currently available on the internal rating based approaches.
Scope of use of internal models	
Exposures to banks, other financial institutions and corporates	
"Banks, other financial institutions and large corporates are usually considered to be low-default exposures, which, as described above, make reliable parameter estimation difficult. Furthermore, such exposures are usually highly rated by credit rating agencies and are the subject of significant market analysis. It is unlikely, therefore, that banks' internal estimates of potential defaults or losses from such exposures will be any more reliable from a supervisory perspective than using estimates based on market data, on which the standardised approach to credit risk is based. As a result, the Committee proposes to remove the IRB approaches for exposures to banks, other financials and large corporates. It also proposes to remove the use of the A-	•Advanced approaches can be properly applied to banks, other financial institutions, and large corporates even though they are low default portfolios as models properly quantify credit risk, incorporate adequate levels of conservatism through low default approaches where misalignment compared to external ratings are identified. Rating agencies are used as a benchmark to test internal models thus driving consistency and internal models. This allows Banks to develop their own approach and to challenge rating agency ratings.



IRB approach for certain other corporates, where it is judged that there is typically insufficient data to estimate LGDs reliably.”	
Committee proposes to remove the IRB approaches for exposures to banks, other financials and large corporates. It also proposes to remove the use of the A-IRB approach for certain other corporates, where it is judged that there is typically insufficient data to estimate LGDs reliably.”	•Some modelling approaches are deemed robust, aligned to best practice and used by major rating agencies •Models are tested through back-testing processes and where issues are identified adjustments to parameters are considered. •Step up risk weights not appropriate for less developed economies •The proposal to remove the option to use IRB approaches for certain exposures could reduce banks’ incentives to develop and use more risk sensitive advanced approaches which should not be the desired result
We feel that disallowing both AIRB and FIRB in favour of Standardised is excessive. At the very least, FIRB should remain available. This is because although the absence or low number of defaults directly affects ability to model LGDs and EADs, the PDs still can be modelled robustly. In an LDP context, absence or low number of defaults still informs the inferences to be made about underlying portfolio PD at a given conservatism level (e.g. Pluto-Tasche approach). For smaller portfolios, the Pluto-Tasche approach is punitive, as it will result in wider confidence intervals for PDs. The width of the confidence interval under Pluto-Tasche can be reduced through the use of external data. In order to assess comparability and reduce RWA variability between banks, regulators could focus on standardising benchmarking requirements / maximum deviations under FIRB and AIRB (e.g. common rating samples of large international banks with publicly available information and maximum deviation thresholds), rather than sacrificing granularity in favour of the Standardised approach.	
Specialised Lending - slotting	
The Committee proposes to remove the IRB approaches for specialised lending that use banks’ estimates of model parameters. This reflects its expectation that banks are typically unlikely to have sufficient data to produce reliable estimates of PD and LGD. The	•This proposed framework has the potential to constrain capital from commercial Banks which will affect growth in developing economies, in particular in Africa



Committee proposes to leave only the standardised approach and the current IRB supervisory slotting approach	• This will affect commercial bank's ability to provide development finance for key infrastructural developments in Africa. • For project finance, banks have to apply a specialised methodology and get regulatory approval where required. • Infrastructure development deals typically rely on government or development banks guarantees, resulting in low PDs and RWA coverage. Other collateral is also recognised when structuring deals. • Under the proposed Slotting approach, the RWA will not be as responsive to recognition of support/collateral as under AIRB. This will affect the banks' ability to finance infrastructure development at relatively low rates, potentially pushing this business into the "shadow banking space". • Banks still need an internal rating model to generate a rating in order to determine which bucket a client will fall into. Banks thus need to have all the governance and controls around the models in place. Although the capital outcome could be different to the internal calculations via models. • There are sufficient defaults in some portfolios, particularly income producing real estate (IPRE), where 40-100 defaults per year is not unreasonable for medium to large banks focusing on commercial property. • The intention to introduce a minimum downturn LGD adjustment will already cater for the potential higher cyclicalities in these portfolios. The IPRE exposures will be subject to the 15% LGD floor for exposures secured by commercial real estate.
---	---



	• The supervisory slotting approach allows for limited discrimination with only four performing categories, and the worst risk weight is less than four times the best risk weight. • The minimum risk weight of 70% discourages low risk deals. The bulk of specialised lending exposures are IPRE where over-collateralisation is common. • The risk weights do not consider the local environment – for example a higher inflation environment is conducive to lower risk income producing real estate portfolios The calibration of the capital floor based on the standardised approach, the LGD floor and the intention to introduce a minimum downturn LGD adjustment will already increase the capital requirements and reduce the variability in this portfolio. Therefore we recommend that the AIRB approach remains as an option for specialised lending portfolios with a minimum number of defaults to ensure that banks have enough data to build reliable models.
Counterparty credit risk and CVA	
“As a result, the Committee proposes to retain IMM-CCR, but subject to a floor based on a percentage of the applicable standardised approach. In the case of derivatives exposures, the applicable approach is the standardised approach to counterparty credit risk (SA-CCR); in the case of securities financing transactions (such as repos), the applicable approach is the formula set out in paragraph 164 of the proposed new standardised approach to credit risk”	• Conceptually the SA-CVA method of calculation is better but without emerging market involvement in the calibration it could end up being punitive for emerging markets where often the only possible hedges are to the exposure component of CVA. • Lack of liquid hedges in the underlying credit derivative market which is unlikely to build or grow given other emerging regulations • The lack of recognition for proxy hedges does not consider the fact that CVA by its nature is a correlation issue



Parameter floors	
"The Committee proposes applying floors to PD, LGD and the credit conversion factors (CCF) used to determine EAD for off-balance sheet items. These floors will only affect the portfolios that remain eligible for use of the IRB approaches and are summarised in Table 2"	• Instead of floors at the parameter level, the Committee should consider establishing further enhancements in the modelling methodology and validation practices, as well as regulatory oversight to ensure consistency and applicability/accuracy in approaches • The creation of floors particularly for LGDs and CCFs may result in inconsistency in how the calculation is applied. Flooring the CCF but changing the calculation for LGD has the potential to take you back to the same EL number hence no change in outcome. • Within the retail space, introducing parameter floors at an account-level removes the incentive to create sufficiently granular pools within a portfolio that differentiate risk accurately, which is ultimately what the models should be capturing – to identify the higher risk segments.
Parameter estimation practices and fixed supervisory parameters	
Probability of default	
"Rating systems should be designed in such a way that assignments to rating categories generally remain stable over time and throughout business cycles. Migration from one category to another should generally be due to idiosyncratic or industry-specific changes rather than due to business cycles"	• Within the retail space it is unrealistic for the rating systems to not be related to business cycles • Rating systems are also generally used as early warning indicators for risk deterioration, and if they were changed to remain stable over business cycles, this potential increase in risk may not be captured dynamically enough.
Loss given default	
• A-IRB: unsecured exposures (corporate and retail) • A-IRB: fully and partially secured exposures (corporate and retail)	• The floor has a significant impact on capital requirements - adding additional conservatism although the historical data shows that some of the floors are not



	relevant – this could incentivize less segmentation of the portfolio. • For collateralised portfolios the work-out calculation would be challenging as we would need to split out the unsecured and secured components • Allocation of collateral to individual account level where multiple collaterals or cross-collateral clauses are in effect will make compliance with the proposal onerous. • It is not clear, but will real-time valuations of collateral be required under the proposal? • Flooring the downturn adjustment to LGD also negates differing business practices during recession, when compared to the current practice of using actual LGD over a predefined downturn period. As a result, there will be less incentive to be risk averse during recession if the capital benefits cannot be realised
The calculation of downturn LGDs is a significant source of RWA variability. To address this, and to help improve comparability, the Committee proposes that banks must separately estimate for non-defaulted assets: (i) a long-run average LGD for each exposure; and (ii) an add-on to reflect the impact of downturn conditions. The LGD parameter will be the sum of these two components.	Will this add-on be prescribed or will the banks model it individually? In either case, it is unlikely to result in consistency of dLGDs.
Exposure at default and credit conversion factors	
“The Committee’s analysis has found that practice-based differences in banks’ estimates of CCFs for undrawn exposures contribute materially to RWA variation among IRB banks. These practice-based differences arise from the difficulty with treating low-default exposures, vague legal concepts and other estimation issues”	• CCFs for certain portfolios are currently low due to operational processes built in to prevent excessive drawdown once accounts have breached certain thresholds • The CCF floor thus doesn’t consider the level of utilisation. This disincentives banks to have better risk management practices. As banks that control limit utilization in a more



	effect manner still require to hold the same minimum EAD
EAD estimates must use a 12-month fixed horizon estimation approach.	The EAD model estimates exposure at default at any point within the next 12 months. Therefore, the EAD estimates should be developed over a variable lag prior to default – considering each point from 1 month to 12 months. Specifying the lag of 12 months exactly will also reduce the number of data points available for EAD modelling and testing. Our recommendation is that the banks be given discretion to use either the fixed 12 month lag or variable (within) 12 month lag.
Credit risk mitigation	
When certain credit derivatives and similar products are used as credit risk mitigants, banks using the IRB approaches may apply the double default treatment. This treatment adjusts assumptions in the capital requirements formula about the probability of both the underlying obligor and the protection provider defaulting. The Committee proposes to remove the double default approach due to its complexity and the lack of evidence of its use by banks	•The concept and use of double default is valid. Specifically for entities where there is no correlation displayed. •The current framework for double defaults is onerous although it remains valid •It is highly unlikely for there to be a situation where the guarantor has failed due to a guarantee being in place
Concluding remarks	
•While an effective application of these floors would reduce variability, we note that it would be overly punitive to entities that have lower risk, with a lower risk profile and/or more rigorous credit risk management practices and we are concerned with the incentives that would create. •The framework seems counterintuitive, as the standardised methodology seems to be applied to low default portfolios which are larger exposures of lower risk whereas the advanced methodology with floors are to be applied to “higher risk” portfolios encouraging high risk business as returns will be higher with less capital requirements – systematically increases risk •We stress the importance of ensuring that internal ratings based (IRB) approaches retain a prominent position within the capital framework	



- Going back to a “standardised” methodology could have undesirable consequences in terms of the potential for misalignment on internal risk assessment
- Banks have made significant investments in developing risk sensitive models, rating systems and processes when Basel II was implemented. These models, systems and processes have been fully integrated into Banks overall risk management framework
- Ideally, where the models/parameters can be enhanced, we believe alternatives should be considered
- Considerable amount of system, process, and methodology changes are required to implement the proposed changes thus, sufficient lead time to fully implement the final changes will be required
- If the aim of this change is to ensure consistency/conservatism, should the focus not be on the strengthening and consistency of benchmarking and validation across banks, while retaining the current regime?

