CRISL Observation on the proposed revisions to the standardised approach for credit risk

1.0 Background:

The Basel Committee on Banking Supervision seeks to substantially improve the standardised approach for credit risk in a number of ways.

These include:

- reducing reliance on external credit ratings;
- increasing risk sensitivity;
- reducing national discretion;
- strengthening the link between the standardised approach and the internal ratings-based (IRB) approach;
- and enhancing comparability of capital requirements across banks.

The Basel framework's current standardised approach prescribes the use of external credit ratings to determine certain exposures' risk weights.

The Committee is investigating the suitability of substituting references to ratings with a limited number of risk drivers that provides a meaningful risk differentiation.

These alternative risk drivers have been selected on the basis that they should be simple, intuitive, readily available and capable of explaining risk consistently across jurisdictions.

Given the challenges associated with identifying risk drivers that can be applied globally, but that also reflect the local nature of some exposures – such as retail credit and mortgages, the Committee recognises that the proposals are still at an early stage of development. It therefore seeks respondents' views and data to enhance the proposals in this consultative document.

The credit risk standardised approach treatment for sovereigns, central banks and public sector entities are not within the scope of these proposals. The Committee will consider these exposures as part of a broader and holistic review of sovereign-related risks.

2.0 CRISL Comments

While reviewing the rationale of the proposed modifications, it has been observed that the authorities are contemplating that the External Credit Ratings have become a blocking factor in implementing the policies and principles of Basel-II and ratings are used or construed as a substitute of credit analysis. But in practice the situation is not like that. In Bangladesh, most of the banks are now using the services of ECAIs under a strict control mechanism where in each and every ECAIs are reporting the ratings on quarterly and the central bank has been reviewing the ECAI ratings on regular basis. Majority of the banks have got the counterparty loans rated. Some of the local banks got the ECAI rating against

85% of the financing. As a result the banks are now in a position to ascertain how much of the counterparty loans are in AAA category, AA Category, BB category and so on which has been assisting the bankers to ascertain the risk it has undertaken.

In addition, the ECAI ratings are assisting the supervisory process in the sense that unrated clients are being looked into seriously to charge additional capital on the basis of its merit and flaws. In developing countries, where lending process are affected by conflict of interest, poor corporate governance, the ECAI ratings are assisting the banks and banking officials in minimizing the conflict of interest and ECAI ratings are used as a bench mark in the process.

Globally financial statements of the corporates are yet to be compliant to all IFRS and Accounting standards and IFAC itself provided number of options of financial reporting, mere reliance on few ratios to arrive at financing decision and capital requirement calculation may take the banking institution few step backward.

Considering the advantage of risk management by using the ECAI ratings, in Bangladesh, the central bank has already raised the risk against SME financing to 100% (in place of 75%) unless the same is rated by ECAI. Through ECAI ratings a counter party may face 50% to 150% risk weight.

3.0 Para-wise comments

For the main exposure classes under consideration, the key aspects of the proposals are:

	Bank exposures would no longer be risk-weighted by reference to the external credit rating of the bank or of its sovereign of incorporation, but**they would instead be based on a look-up table where risk weights range from 30% to 300% on the basis of two risk drivers: a capital adequacy ratio and an asset quality ratio.**	It will be very simple and liberal approach and contradictory to the objective of the proposal such as increasing risk sensitivity. More over the ratios are normally used for just trend analysis and cannot be used for concluding on a serious issues like capital determination in reference to risk. In addition, replying on only two ratios will reduce the risk sensitivity which is contrary to the BIS objective. The existing Basel-II documents provided wide discretion at the national jurisdiction which has ultimately favoured implementation of the Basel globally at the shortest possible time. In addition, Financial reporting standards globally are still not the same on the basis of which the proposed ratios are to be based. One of the most important inertia of the Basel Committee is that the banks must have capital in commensurate with the risk undertaken. If the Risk management is the objective, mere simplification even more than what a banks look into in financing a client ,will be less effective and ultimately dilute the capital requirement.

<table>
<tr><td></td><td></td><td>An asset quality ratio may not represent important off balance sheet information such as loan rescheduling, loan write-off, loan-restructuring, large loan concentration, sectoral concentration, single borrower risk concentration, drive to recover written-off loan , Provision shortfall against loan exposure, Loan without collateral, Filing of suit to recover non-performing loan & its progress status, Movement of NPL, Regularization/declassification of loan through improper/ malpractice of rescheduling.

Other aspects that has lacking in the proposed proposal are: Liquidity management and liquidity position of a bank during a particular tenure and contingency plan and its appropriateness towards liquidity management is also absent.Moreover, overall corporate governance & compliance & risk management practice of a bank from different perspective are absent in this proposed document.

Few mentioned of above shortcomings further insist that risk-weight of a bank , which is currently being done by external credit rating under standardized approach after long time in-depth analysis by ECAI should countinue. Assigning risk weight merely applying two ratios and ignoring all the above mentioned factors will give wrong signal & interpretation about a particular bank.</td></tr>
<tr><td></td><td>Corporate exposures would no longer be risk-weighted by reference to the external credit rating of the corporate, but they would instead be based on a look-up table where risk weights range from 60% to 300% on the basis of two risk drivers: revenue and leverage. Further, risk sensitivity would be increased by introducing a specific treatment for specialized lending.</td><td>Replacing existing risk-weight for corporate exposure based on external credit rating (under standardized approach) through introducing two risk drivers will be not effective or meaningful. Rather will create the exposure more riskier due to straight application two factors: revenue & leverage.

Drawbacks or shortcomings of application of two drivers for risk weighting corporate exposure are as below:

1. Revenue disclosure in many corporate accounts is not in line with accounting standard and does not truly reflect actual scenario. It varies from sector to sector and may be affected by seasonal effect. It is also affected due to change of any Govt. policy, rules, regulation or Govt. support.Moreover , the profitability and the revenue linked with the cash flow may not go in the same line hence may not reflect the the revenue alone.
2. Leverage structure of corporate varies from sector to sector and it can not be harmonized.
3. Preparation of fictitious or over stated financial statements will be encouraged
• Qualitative aspects such as governance, delegation, compliance of sector specific rules & regulation are ignored.
• Business risk of corporate is ignored
• Operational risk & other sector specific risk is ignored
• Utilization of loan , repayment track record is</td></tr>
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		ignored 4 Existing exercise of standardized approach of corporate rating covering all the above aspects can give true position and risk-weight of corporate. Basel committee, may consider risk weighting of unrated corporate exposure based on above two risk drivers and other relevant factors. However, the range of revenue & leverage should be determined by country regulator and also it should vary for sector to sector. In case of special lending (exposures against project finance, object finance, commodities finance and income-producing real estate finance, exposures to land acquisition, development and construction finance), risk weight should be assigned based on rating of external rating agency in case of project finance and exposure against income-producing real estate finance, exposures to land acquisition, development and construction.
	The retail category would be enhanced by tightening the criteria to qualify for the 75% preferential risk weight, and by introducing a fallback subcategory for exposures that do not meet the criteria.	Considering the advantage of having ECAI rating which levels all risk into certain symbols and risk category, the regulators in some jurisdiction introduced rating for retail category of financing. In Bangladesh, any financing to SME above Taka 3 million is to face 100% risk weight unless it is rated and the risk weight for rated entities are as per ratings mapped with the central bank risk category.
	Exposures secured by residential real estate would no longer receive a 35% risk weight. Instead, **risk weights would be determined according to a look-up table where risk weights range from 25% to 100% on the basis of two risk drivers: loan-to-value and debt-service coverage ratios.**	**Application of loan-to-value and debt-service coverage ratios are two good risk drivers for assigning risk weight to** Exposures secured by residential real estate. However, both the ratios should be calculated on continuous basis rather than only at the time of loan origination. Moreover, there should be a common valuation methodology and property should be valued after a certain interval.
	Exposures secured by commercial real estate are subject to further consideration where two options currently envisaged are: (a) treating them as unsecured exposures to the counterparty, with a national discretion for a preferential risk weight under certain conditions; or (b) **determining the risk weight according to a look-up table where risk weights range from 75% to 120% on the basis of the loan-to-value ratio.**	No option is better than ECAI rating
	The credit risk mitigation framework would be amended by reducing the	Initiative for changes in eligibility criteria by Basel committee is timely.

	number of approaches, recalibrating supervisory haircuts, and updating corporate guarantor eligibility criteria.	
	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?	Selection of the capital adequacy ratio is prudent for risk-weighting bank exposure. CET-1 ratio is superior to Tier-1 ratio or leverage ratio. However, it should not be considered on stand alone basis.
	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?	Net NPA ratio is an effective driver for distinguishing a bank exposure's credit risk. However, the same cannot be taken on stand alone basis without due consideration to the following: 1. loan rescheduling, 2. loan write-off 3. loan-restructuring 4. large loan concentration 5. sectoral concentration 6. single borrower risk concentration 7. drive to recover written-off loan 8. Provision shortfall against loan exposure 9. Loan without collateral 10. Filing of suit to recover non-performing loan & its progress status 11. Movement of NPL 12. Regularization/declassification of loan through improper/ malpractice of rescheduling
	Q3. Do respondents have views on the proposed treatment for short-term interbank claims?	Risk weight for short-term interbank claims should be based on short term rating of bank done by a external credit rating agency rather than 20 percentage point reduction to the risk weight assigned by the table in paragraph [13],
	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?	Banks not subject to the Basel III standards would be requested by their creditor banks to calculate and disclose the CET1 and net NPA ratios in accordance with the Basel III requirements, so as not to be subject to the highest risk weight.
	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?	Consideration of leverage as well as off-balance sheet exposure is a good driver for understating credit risk of corporate exposures. But to judge credit risk of corporate exposures a total analysis of corporate is required covering various aspects of corporate which ultimately depicts a corporate's ability to pay off bank liability. In this case, ECAI rating is the best option to level all risk into a risk category.
	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?	Maximum SME does not have structured accounts and formal management system in place ; hence calculation of leverage will be next to impossible in case of SME and moreover, turnover will be also not justified. In that case a total analysis should be based on qualitative factors , bank statement analysis, physical

		inspection of operation and control of collateral held against exposure.
	Q7. Do respondents think that the risk sensitivity of the proposal can be further increased without introducing excessive complexity?	
	Q8. Do respondents agree that introducing the specialised lending category enhances the risk sensitivity of the standardised approach and its alignment with IRB?	Special lending category (exposures against project finance, object finance, commodities finance and income-producing real estate finance)can be introduced to understand more risk sensitivity of the standardised approach,. But risk weighting of exposure should be based on total analysis of project finance, income-producing real estate finance , and exposures to land acquisition, development and construction finance .
	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?	
	Q10. Do respondents agree that LTV and/or DSC ratios (as defined in Annex 1 paragraphs 40 and 41) have sufficient predictive power of loan default and/or loss incurred for exposures secured on residential real estate?	Both the indicators are good driver for calculating probability of default or loss incurred out of exposures at default. But two ratio should be calculated on reasonable continuous basis.
	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.)	No, both the ratios should be calculated regularly rather than only at time of loan origination. Property should be valued at a regular interval and there should be unique property valuation methodology.
	Q12. Do respondents have views on whether the use of a fixed threshold for the DSC ratio is an appropriate way for differentiating risks and ensuring comparability across jurisdictions? If not, what reasonably simple alternatives or modifications would respondents propose while maintaining consistent outcomes?	DSC ratio should not be fixed ; rather it should have different range and should be left to national regulator to fix the range considering country’s tax & other relevant policies(if any).
	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?	These two drivers are sufficient enough

	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?	None of two options is appropriate to assign appropriate risk against the exposure backed by commercial real estate. As the risk of exposure is very much correlated to real estate business scenario of the particular country which again differs from country to country, and based on Govt. tax policy, incentive, inflation, real purchasing power of people in economy and more specifically borrower's position in the industry, exposure should be rated by a external rating agency to determine borrower's ability to discharge liability.
	Q15. What other options might prudently increase the risk sensitivity of the commercial real estate treatment without unduly increasing complexity?	No option is better than ECAI rating
	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?	risk weight add-on should not only be applied to retail exposures and exposures secured by residential real estate, but also may be applied to other exposure whether there is chance of currency mismatch.
	Q17. Do respondents consider the categories for which a CCF is applied under the standardised approach to be adequately defined?	Proposed changes in CCF by basel committee considering changed circumstances is timely but circumstances should be adequately defined.
	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.	Proposed changes in CCF by Basel Committee will be more meaningful to ascertain more accurate risk weight against off-balance sheet exposure .
	Q19. What are respondents' views on the alternative treatments currently envisaged for past-due loans?	For past-due loan risk weight should vary not only on the basis of provision kept, value of security kept against past-due loan should be taken into consideration while assigning risk weight.
	Q20. Do respondents agree with the proposed treatment for MDBs?	Proposed changes by Basel committee is appropriate.
	Q21. What exposures would be classified under "Other assets"? Is a 100% risk weight appropriate? (Please provide evidence where possible).	Current risk weight of 100% is all right for other assets.
	Q22. What are respondents' views on the above alternative ways to define eligible financial collateral?	jurisdictions that cannot use external ratings in their regulations, alternative criteria to external ratings as proposed by committee is justifiable. But where external rating is possible , issue rating of instrument should continue for eligibility criteria of financial collateral.
	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	Rating has been accepted in most of the jurisdiction as a means to level all categories of risk into a system. The above has eliminated a large number of financing conflicting factors. Rating as a third party view has brought awareness to be

	from the supervisory haircuts table? What could be the implications of eliminating references to external ratings?	careful in financing project. Therefore ECAI ratings should continue as a best alternative unless a bank goes for IRB approach
	Q24. What are respondents' views on the proposed corporate guarantor eligibility criteria?	Existing practice rating under standardized approach should continue expect guarantee given by sovereign entity or MDB.