Eskan Bank (Bahrain) Comments on the Proposed Revision to the Standardized Approach to Credit Risk (Issued For Comment by 27 March 2015)

Basel Proposal	Eskan Bank's Comments

Basel Proposal

1. **CHANGE IN THE RISK WEIGHTING METHODOLOGY FOR BANK EXPOSURES:**
   - These would no longer be risk-weighted by reference to the bank's external credit rating or that of its sovereign of incorporation, but would instead be based on two risk drivers: the bank's capital adequacy and its asset quality.
   - The risk weights range from 30% to 300% based on the obligor Bank's CET1 and net NPA ratios, such that Bank with higher CET1 ratio and lower NPA ratio will have a lower risk of default and therefore receive a lower risk weight.
   - The details for these two drivers will be obtained from the most recently published Pillar 3 disclosures.
   - Higher risk weight of 300% will be applied if disclosures are not made on timely basis.

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The credit rating of the bank is considered as a comprehensive assessment of the bank's business as many factors are considered while assessing the Bank's credit rating such as macro factors (economic risk and industry risk), bank specific factors (business position, capital and earnings, risk position, funding and liquidity), external support (shareholder support, government support) etc. Only considering two risk drivers and disregarding a comprehensive assessment where available may have the following implications:

i. **Narrowing the assessment based on only credit risk of the bank and disregarding other key risks**:
   Disregarding the Credit rating methodology to only two risk drivers will carry the risk of narrowing the assessment on two ratios which are primarily reflective of the credit risk of the bank.
   CET1 ratio only considers Credit Risk exposures, Market risk exposures and Operational risk exposures in this calculation. It disregards Liquidity risk, interest rate risk, etc. which have been found to be equally important, if not more, post the sub-prime crisis.
   CAR ratio based on a detailed CAAPs assessment would be more ideal. However, consistency in methodology and application across the countries remains an issue.

ii. **Skewing of results:**
   Based on the proposed change in methodology and the risk weight table, an illustration is given below to reflect the nature of skewness that may be expected using the proposed methodology for assigning risk weights

<u>Table 1: Current Risk weight table for Banks (Central bank of Bahrain rulebook module CA):</u>

Banks Credit Quality Grades	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Standard risk weights	20%	50%	50%	100%	150%	50%
Preferential risk weight	20%	20%	20%	50%	150%	20%

<u>Table 2: New Proposed risk weight table for Banks:</u>

	CET1ratio ≥ 12%	12% > CET1 ratio ≥ 9.5%	9.5% > CET1 ratio ≥ 7%	7% > CET1 ratio ≥ 5.5%	5.5% > CET1 ratio ≥ 4.5%	CET1 ratio < 4.5%

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Net NPA ratio ≤ 1%	30%	40%	60%	80%	100%	300%
1% < Net NPA ratio ≤ 3%	45%	60%	80%	100%	120%	
3% < Net NPA ratio	60%	80%	100%	120%	140%	

Table 3: Comparison of risk weights based on current rating methodology versus new proposed methodology

	CET1 Ratio	**Net NPA**	**Rating**	**Current RWA (Based on credit rating)**	**Proposed RWA**
Standard Chartered Bank (Annual report 2014)	10.7%	2.0%	AA-	20%	60%
Ahli United Bank (Pillar 3 disclosure H1 2014)*	11.6%	0.2%	BBB+	50%	40%
Bank of Bahrain and Kuwait (Annual report 2014)*	15.6%	2.0%	BBB+	50%	45%

**Tier 1 CAR is considered in the absence of information on CET1 ratio.*
Note: Central bank of Bahrain has mandated a minimum CET1 ratio (including CCB cover) of 9% for Bahrain based banks.

From the Table 3 above it is noted, that Standard Chartered Bank, a multinational Bank having a huge base of operations worldwide will get assigned a lower risk weight compared to local banks who have presence primarily in Bahrain and other GCC countries. Thus basing the assessment on only two risk drivers as proposed by the Committee may not be a true reflection of the obligor bank's risk assessment.

iii. Figures considered are at a point in time and may not be reflective of the true standing of the Bank during the year.

The information in disclosures are static and only reflect the as of date position of the reporting entity,

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	whereas a credit rating would consider the various metrics during the assessment period along with future prospects and its impact on the entity, therefore making a rating assessment more dynamic. **Conclusion:** It may be worthwhile to continue to use rating as a benchmark of assigning risk weights where available. For unrated banks, the proposed methodology of referencing the risk weight to the risk drivers may be adopted instead of a standard risk weight of 50% currently used (refer table 2 above). It is also recommended that the risk drivers to be expanded to include liquidity risk and other risks in the assessment.

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2. **CHANGE IN THE RISK WEIGHTING METHODOLOGY FOR CORPORATE EXPOSURES:**

   - These would no longer be risk-weighted by reference to the borrowing firm's external credit rating, but would instead be based on the firm's revenue and leverage.
   - Further, risk sensitivity and comparability with the IRB approach would be increased by introducing a specific treatment for specialized lending.
   - Special risk weight treatment is proposed for specialized lending to corporates falling in the categories of Project Finance, Object Finance, Commodities finance, Income producing real estate, land acquisition, development and construction lending. The risk weights assigned will higher of the i) risk weight applicable to the counterparty as per table 4 above or ii) 120% for Project Finance,

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i. **General lending to Corporates:**

Table 4: New proposed Risk weight table for Corporates:

	Revenue ≤ EUR 5m	EUR 5m < Revenue ≤ EUR 50m	EUR 50m < Revenue ≤ EUR 1bn	Revenue > EUR 1bn
Leverage: 1x - 3x	100%	90%	80%	60%
Leverage: 3x - 5x	110%	100%	90%	70%
Leverage > 5x	130%	120%	110%	90%
Negative equity[1]	300%			

[1] Negative equity means that a corporate's liabilities exceed its assets.

Continuing on the same line of argument as mentioned above for banks, basing the risk weights on only two risk drivers of firms' revenue and leverage will have similar implications as below.

Moreover, unlike financial institutions, corporates in Bahrain are not stipulated to publish their financials in a time-bound manner. Hence the information in the financials may be outdated and not be reflective of the current position of the entity.

The risk drivers of revenue and leverage again disregards the liquidity risk of the firm, the shareholder strength, the country of operation, etc. which are some of the criteria used by rating agency in their assessment.

Table 5: Current Risk weight table for Corporates (Central bank of Bahrain rulebook module CA):

Credit assessment	AAA to AA-	A+ to A-	BBB+ to BB-	Below BB-	Unrated
Risk weight	20%	50%	100%	150%	100%

ii. **Specialized lending to Corporates:**
The introduction of a specialized lending category is welcomed as these types of lending can be segregated from the other general lending to Corporates.

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Object Finance, Commodities finance, Income producing real estate, 150% for land acquisition, development and construction lending	However, the risk weights assigned to these lending seem to be too aggressive. Specialized lending are similar to secured lending wherein the Bank has priority on the cashflows generated from the underlying project, commodity, or the income generating property. Moreover, additional collaterals are taken by banks in the form of corporate guarantee or other securities to further secure the exposure. As such specialized lending should attract a lower weight compared to general exposures to corporate which are more likely to be unsecured in nature **Conclusion:** **i.** General lending criteria: It may be worthwhile to continue to use rating as a benchmark of assigning risk weights where available. For unrated entities, the proposed methodology of referencing the risk weight to the risk drivers may be adopted instead of a standard risk weight of 100% currently used (refer table 5 above). It is also recommended that the risk drivers to be expanded to include liquidity risk and other risks in the assessment. **ii.** Specialized lending: It is recommended to re-assess the risk weights being proposed for this category and to make it more relaxed compared to general exposures to Corporates.
3. CHANGE IN THE QUALIFICATION CRITERIA AND RISK WEIGHTING TREATMENT FOR RETAIL EXPOSURES: o Retail category would be enhanced by tightening the criteria to enforce a 0.2% numerical limit to qualify for a preferential risk weight, and by o To seek evidence or inputs 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 o To introduce an alternative	1. **To differentiate based on product sub-categories:**The committee may wish to differentiate the retail exposures based on product sub-categories primarily distinguishing between secured lending (automobile loans, consumer durables, etc.) and unsecured lending (credit card, personal loans). Higher risk weights may be assigned to unsecured lending portfolio.

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<tr><td>treatment for other retail exposures that do not meet the criteria.</td><td></td></tr>
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4. CHANGE IN THE RISK WEIGHTING METHODOLOGY FOR EXPOSURES SECURED BY RESIDENTIAL REAL ESTATE:

- These would no longer receive a 35% risk weight. Instead, risk weights would be based on two commonly used loan underwriting ratios: the amount of the loan relative to the value of the real estate securing the loan (i.e. the loan-to-value ratio) and the borrower's indebtedness (i.e. a debt-service coverage ratio).
- Additional criteria proposed to qualify for the risk weight treatment of a residential real estate exposure:
  - Finished property
  - Legal Enforceability
  - Prudent value of property

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<u>Table 6: New Proposed Risk weight table for Exposures secured by Residential real estate:</u>

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<tr><th></th><th>LTV < 40%</th><th>40% ≤ LTV < 60%</th><th>60% ≤ LTV < 80%</th><th>80% ≤ LTV < 90%</th><th>90% ≤ LTV < 100%</th><th>LTV ≥ 100%</th></tr>
<tr><td>Loans to individuals with [DSC ≤ 35%]</td><td>25%</td><td>30%</td><td>40%</td><td>50%</td><td>60%</td><td>80%</td></tr>
<tr><td>Other loans</td><td>30%</td><td>40%</td><td>50%</td><td>70%</td><td>80%</td><td>100%</td></tr>
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1. <u>**Risk drivers proposed above are based on Static data:**</u> The risk drivers of DSC and LTV given in the table above are derived from the information available at the time of loan disbursal. These will be considered for the assignment of risk weight for the particular exposure throughout the life of the loan unless loan goes into default. However using the static ratios over a tenor of 25 to 30 years will not provide any significant ability to determine the risk characteristics of the exposure. At the same time it is understood that updating information at each exposure level is also cumbersome and may not be possible for retail portfolio. Given these limitations, having a risk weight assignment based on historical ratios will not add any material value but make the risk weighting exercise more complicated given the multiple risk weights for each combination of DSC and LTV.

2. <u>**Differentiation between buying house for self occupation versus investment property may be considered**</u>: it is generally seen that the loans against owner occupied properties are less sensitive towards changes in market value of the properties as compared to properties bought for the sake of investment. It is recommended to consider this aspect while defining the risk weight buckets.

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5. CHANGE IN THE RISK WEIGHTING METHODOLOGY FOR EXPOSURES SECURED BY COMMERCIAL REAL ESTATE:

- Two options are currently under consideration:

  (a) treating the exposures as unsecured with national discretion

</td><td>Concur with LTV based approach on assigning risk weights. However the problem of using static ratio of LTV for determining the risk weight as explained above needs to be looked into.</td></tr>
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for a preferential risk weight under certain conditions; or (b) determining the risk weight based on the loan-to-value ratio.	