Indian Banks' Association

IBA's response to second consultative document on Revisions to the Standardised Approach for credit risk

We give below our comments on the above Consultative document as follows:

	BCBS proposals	**IBA 'S Observations**
1)	The application of risk weights in exposure to banks and corporates are based on due diligence requirements of these exposures besides their external rating.	More clarity is required on the concept of " Due Diligence". The due diligence parameters should be defined in the guidelines to avoid subjectivity and enhance the comparability.
2)	Reducing mechanistic reliance on external ratings: introduction of need for due diligence while assessing Pillar 1 capital	The requirement of due diligence in addition to the use of external rating will operationally involve the referring to the internal rating (derived as a part of the credit assessment process) and a final risk weight based on a 'lower of the two' approach. Further, the use of a 'lower of the two' approach may result in complications while implementing other metrics such as pricing, capital allocation and portfolio planning and monitoring in the bank. Our suggestion is that the individual regulators of each jurisdiction may consider using the PD data from rating agencies and LGD data from banks to determine more accurate calibrated standardised risk weights which may thereafter be applied by the banks. This may facilitate comparability and ensure simplicity.
2)	Exposure to Banks: Feasibility and appropriateness of using bank's ratings without factoring in government support.	At present external rating agencies rate banks taking into consideration the government support as well. Hence at present the proposal is not feasible. Going forward, the rating agencies need to bring out differential ratings one with government support and other without it.
3	**Project Finance** The proposed standardised approach introduces a differentiation between corporate exposures and specialised lending. In particular, it allows for issue specific external ratings to be used for project, object and commodity finance (with the same applicable risk weights as corporate debt). In case of unrated project finance exposures, 150% and 100% risk weights have	Under the current framework, an unrated project finance exposure would receive a risk weight of 100%. In case of emerging markets, there is need for rapid credit growth to meet various infrastructure-financing needs. Same is the case with India as well. Accordingly, banks in India need to grow rapidly so that previously unbanked sections of the population can be reached. Also, the absence of development financial institutions and lack of deep bond markets, the burden of funding

	been prescribed in the pre-operational and operational phases respectively.	infrastructure requirements depend heavily on bank financing. Considering this vast project requirements in India, the proposed 150% risk weight applicable during the pre-operational phase of the project may be punitive and may dis-incentivise project lending which is crucial for the overall economic progress of the country. Further, the proposed 150% risk weight is more conservative than IRB supervisory slotting approach where risk weights range from 70% to 115% for strong/ good/ satisfactory projects.
4	**Real Estate** A) With respect to CRE, LTV based banding will have to be carried out as the current approach only distinguishes between CRE-RH (75% risk weight) and non-CRE RH exposures (100% risk weight). The proposed risk-weight buckets for CRE range from 60% to 130%. Land acquisition, development and construction (ADC) lending will be risk-weighted at 150%. ADC includes loans to companies or SPVs financing any of the land acquisition, development and construction of any residential or commercial properties where the source of repayment at origination of the exposure is either the future uncertain sale of the property or cash flows whose source of repayment is substantially uncertain. B) The consultative paper specifies certain operational requirements as pre-requisites for application of LTV based risk weights on real estate exposures. With respect to risk weights for residential real estate exposures where repayment is not materially dependent on cash flows generated by the property, one of the operational requirements stipulates that subject to national discretion, the supervisor may apply the LTV based risk weights on residential property under construction,	Going by this proposal all builder loans will be risk weighted at 150%. Currently, risk weight of 150% is applied only for clients below investment grade. It needs to be highlighted that while giving a loan to a builder for construction of residential or commercial properties, other than the future prospects of the property, the credit profile of the client including the project execution capability is also an important factor. Considering this, a risk weight of 100% or risk weight based on the external rating of the client, whichever is higher, could be considered. Also it may be noted that real estate property as collateral attracts lower LGDs compared to the other assets category as per FIRB rules. The stipulation that the property under construction must not include apartments within a larger construction project may be inappropriate to apply in the Indian context. Residential properties in India are different. The nature of one-to-four family residential housing units are relatively less prevalent and apartment complexes are more common. It may be noted, that a large proportion of mortgage loans in India pertain to mortgages against apartments. Mortgages on apartments may be included in the list of under construction properties where the LTV

	provided that (i) the property under construction is a one-to-four family residential housing unit that will be the residence of the borrower (this does not include apartments within a larger construction project); or (ii) where the sovereign or PSEs have the legal powers and ability to ensure that the property under construction will be finished. In case the above operational requirement along with certain others is not met, the applicable risk weight for exposures of this nature is a flat 100%.	based risk weights may be applied.
5	**Treatment of NPA** The proposed framework recommends that the benefit of specific provisioning should be reflected in the form of a lower EAD but should not result in a lower risk weight. Hence, for unsecured portion of any defaulted exposures net of specific provision and write off, risk weight of 150% is proposed.	It may be noted that the above treatment should consider the LGD for unsecured exposures and ensure that the provisioning (EL) plus capital requirement (UL) should not exceed the downturn LGD applicable to the loan under consideration
6	**Defaulted Exposure : Other forms of collateral** The current framework allows a lower risk weight of 100% where a past due loan is fully secured by forms of collaterals that are not eligible under the CRM framework, provided that provisions reach 15% of the outstanding amount of the loan. The consultative document proposes to remove this treatment on the premise that as the proposed revisions delink risk weights with the amount of provisions, this treatment will be inconsistent.	Since other forms of collateral (like factory land, plant & machinery etc.) have a significant part to play in reducing the LGD of exposures and hence there existence should warrant a lower risk weight than unsecured exposures. Such recognition is not inconsistent with the delinking of provisioning coverage and risk weighting and hence the current framework (of 100% risk weight if secured by other forms of collateral) may be allowed to continue (without specifying any provisioning levels).
7	**Unconditionally cancellable** The proposed framework recommends a 10%-20% CCF for unconditionally cancellable retail commitments (credit cards). However, no concession has been provided for non-retail unconditionally cancellable instruments. The same CCF as that for regular undrawn facilities (50%-75%) is currently proposed.	It may be noted that given the inclusion of the unconditionally cancellable clause in the loan agreement, CCF of 50%-75% may be too punitive and does not reflect any benefit with respect to including such a clause in the loan agreement vis-à-vis a regular undrawn commitment without the clause.

8	**Credit conversion factor for Undrawn Commitments** Consultative document seeks to impose 50%-75% credit conversion factor on commitments regardless of maturity.	We feel that the current treatment (of 20% for commitments with residual maturity upto 1 year and 50% for more than 1 year) may be allowed to continue as intuitively, credit risk increases with tenor.
9	**Unhedged Foreign Currency** The proposed framework recommends a 50% risk weight add on to all 'unhedged exposures' (defined as an exposure to a borrower that has no natural or financial hedge against the foreign exchange risk arising from the currency mismatch between the currency of the loan and the currency applied to pay down the loan). It may be noted that ratings already factor in the credit risk arising out of currency mismatch. Further, operational complexities exist with respect to determining the extent of unhedged exposures (such as assessing currency volatility, estimation of impact on EBIDTA of the borrower etc.).	The RBI currently has in place guidelines for unhedged foreign currency exposures which impose provisioning and risk weighting requirements on companies with certain levels of unhedged exposures in their balance sheets. The overlap between the two requirements may be analysed and amended suitably. Further clarity may be provided on the operational aspects.
10	**Standard Supervisory Haircuts** The consultative document increases the haircut for main index equities (including convertible bonds) and Gold from 15% to 20%.	As the assumption for standard supervisory haircut is 10 day holding period, we feel that the increase to 20% haircut is excessive as empirically these asset classes do not display volatility above 15% (over a 10 day holding period).