

Comments on “Revisions to the standardised approach for credit risk - consultative document”

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?

- Compared with Tier 1 ratio or Total Capital ratio, CET1 ratio is deemed indicative more of capital quality than capital adequacy. The better indicator of capital adequacy should reflect both the quality and quantity of capitals. Therefore, the following alternatives might be considered.
 - Option 1: Capital Adequacy ratio = $W_1 \times \text{CET1} + W_2 \times \text{Tier 1 ratio} + W_3 \times \text{Total Capital ratio}$
($W_1 + W_2 + W_3 = 1$)
 - Option 2: Capital Adequacy ratio = $k \times \text{Total Capital ratio}$
The adjustment factor k can be determined by the ratio of CET1/Total Capital such as the follow:

CET1/Total Capital	50-60%	60-70%	70-80%	>80%
K	N ₁	N ₂	N ₃	N ₄

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?

- NPA ratio is an effective measure of a bank’s asset quality. However, applying this ratio would require a bank disclose and report additional information, such as non-performing lease and non-performing debt securities and other interest-bearing balances. If there is not standardized reporting format or template for the additional NPA information, the bank calculating the net NPA ratio would need extra efforts to locate the information on the reports. Moreover, the obtained numbers might be subject to the user’s interpretation.
- One alternative is to use the Impaired Ratio (gross impaired loans/total loans) or the Impaired Ratio in conjunction with the Allowance Ratio (total allowance /total loans). The NPA ratio is more inclusive than the Impaired Ratio and Allowance Ratio. Nevertheless, the Impaired ratio and Allowance ratio are highly indicative of asset quality and commonly used in measuring and managing credit risks in practice. Additionally, the Impaired ratio and Allowance ratio or the impaired amount and allowance amount can be directly extracted from the current financial reports without interpretation.

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?

- To banks not subject to Basel III (non Basel III banks), the proposed risk-sensitive approach for Basel III banks may be applied.
- For these non Basel III banks, Basel III based capital ratios are unavailable. A balance sheet based leverage ratio (assets/capital) might be used as the alternative measure for capital adequacy.
- The asset quality measures, either the NPA ratio or the suggested Impaired Ratio and Allowance Ratio, should be available for non Basel III banks.

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?

- Revenue is a common measure of a company’s earning strength, but using the revenue in dollar amount might create biased favor for large companies, i.e. companies with large amount of revenue. The suggested alternative is to replace Revenue with the ratio of Revenue/Total Assets. To recognize the

effect of the company's size, the impact of Revenue/Total Assets ratio on risk weight could be differentiated in light of the company's revenue scale such as the follow chart:

Revenue	Up to \$5 million			\$5-\$10 million			\$10-25 million			\$25 million and over		
Revenue/Total Assets	R ₁	R ₂	R ₃	R ₁	R ₂	R ₃	R ₁	R ₂	R ₃	R ₁	R ₂	R ₃
Impact on Risk Weight	RW ₁₁	RW ₁₂	RW ₁₃	RW ₂₁	RW ₂₂	RW ₂₃	RW ₃₁	RW ₃₂	RW ₃₃	RW ₄₁	RW ₄₂	RW ₄₃

- The (Total Debt / EBITDA) might be the alternative of the leverage (Total Assets / Total Equity). This alternative ratio could minimize the difference across different industries and jurisdictions.
- The "Total Debt" of the alternative ratio could contain off-balance sheet exposures.
- The off-balance sheet exposures might be converted to an on-balance sheet exposure by a CCF. To simplify the conversion, a flat CCF of 20% or 50% might be considered.

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?

- If the above Revenue bucketed Revenue/Total Assets is used as the risk driver for risk weight, the expected treatment for SMEs could be applied through RW₁₁, RW₁₂ and RW₁₃ in the "Up to \$5 million" bucket. Therefore, it would not be necessary to have a separate category for SMEs.
- The Committee proposed 110% risk weight for start-up companies is deemed appropriate.

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

- Agree to carve out the specialized lending category from the general Corporate exposure
- Suggest to apply 120% risk weight to across-the-board exposures of Specialized Lending category, because,
 - Even though exposures to land acquisition, development and construction finance might be riskier than other types of specialized lending, a bank normally exercises extra prudence with these riskier loans when determining loan amount and structuring terms and condition.
 - This would ensure consistent implementation to the Specialized lending categories and reduce complexity.

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 suggestion is to allow the bank to use the risk scores or risk ratings that are applied to retail exposures to determine a risk weight.
- The suggested treatment is to calibrate the bank's risk scores or risk ratings to three classes: High risk, Medium risk and Low risk, and assign 100%, 75% and 50% to the three classes respectively. In order to maintain a meaningful and controlled distribution of the calibration and the overall risk weight of the regulatory retail exposures, a ceiling or floor may be established for each risk class. An illustrative calibration ceiling/floor is presented hereunder.

Risk score / rating	Range 1	Range 2	Range 3
Risk Class	Low	Medium	High
Risk Weight	50%	75%	100%
Ceiling/Floor	< 20% of total retail exposure in this group	< 70% of total retail exposure in this group	> 10% of total retail exposure in this group

- Alternatively, a bank may choose to maintain the current treatment of applying a 75% risk weight to all the regulatory retail exposures.
- The additional comments on the Committee proposed 0.2% numerical limit as a binding regulatory standard (ie no aggregate exposure to one counterparty can exceed 0.2% of the overall regulatory retail portfolio):

For banks with significant retail exposures, 0.2% would be too high to be a practical limit. For banks with different size of retail exposure, 0.2% would represent substantially different dollar amounts. For example, if Bank A has \$10 billion overall regulatory retail portfolio and Bank B has \$50 billion overall regulatory retail portfolio. On one hand, \$20 million and \$100 million are too high a limit for retail exposure. On the other hand, exceeding difference exists between the two banks' limits.

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?

- Agree

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.)

- Typical residential mortgage loans last for many years. If the value of the property is kept constant as measured at origination, the subsequent-year LTV might be significantly distorted, especially when the housing market has experienced high volatilities. It is not deemed practical and doable to update property value annually. One alternative is to estimate the current value of the property with the regional housing price index. For example, at the time of origination (t_0), the property value was V_0 and the regional housing price index was I_0 . N years later, the value of the property (V_n) could be estimated by multiplying the original value V_0 by the housing price index adjustment factor (I_n/I_0), i.e.

$$V_n = V_0 \times (I_n/I_0)$$
- For a typical borrower, DSC would likely improve over time. On one hand, the borrower's income likely increases. On the other hand, along with the reduction of mortgage balance, technically the borrower might choose to refinance the lower balance and arrange a lower payment amount. Not updating the DSC ratio over time would probably miss the trend of increasing DSC.

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?

- The DSC should be an effective factor for differentiating risks, but a fixed threshold for the DSC ratio might not be the best way for ensuring comparability across jurisdictions.
- One alternative is to use the Household Gross Income/Loan ratio or Loan/Household Gross Income multiples. The major advantages of this alternative include:
 - Simple
 - Better comparability across jurisdictions
 - Even if the Household Gross Income is kept a constant as measured at origination over time, the declining loan amount would enable the Household Gross Income/Loan ratio or Loan/Household Gross Income multiple to reflect the expected trend in the DSC.

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?

- The first option is viewed as the most suitable for commercial mortgage.

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

- If the income-producing properties are carved out to Specialized Lending and the two risk drivers (revenue and leverage) are introduced to Corporate exposure, it would not be necessary to have a separate category for commercial mortgage and commercial mortgage could be treated as Corporate exposure.
- The preferential 50% risk weight could be recognized through assessment of the commercial property in Credit Risk Mitigation.

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?

- Agree

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

- Agree

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.

- It is deemed a right choice to eliminate the current SA's distinguished CCF for maturity ≤ 1 year and maturity > 1 year.
- CCF should reflect the expected drawn amount which is driven by the two factors: the probability to be drawn and the amount probably being drawn. Based on the two factors, CCF is more related to the type of the loan facility than the maturity of its term length. By the purpose and structure of financing, it could be concluded that the probability being drawn and the amount being drawn of a term loan's commitment is higher than a revolving facility.
- The suggested alternative for "Commitments, except unconditionally cancellable", is,
 - 100% CCF for commitments on term loans
 - 50% CCF for commitments on revolving facilities

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

- Because specific provisions are neither counted into regulatory capital nor considered as "collateral" in Credit Risk Mitigation, the current SA allowed reduction in the required capital when specific provisions are allocated should be retained.
- Furthermore, it may be worthy to consider the option of replacing the current Past-due loans with Impaired Loans category. Even though the number of past-due days is the primary driving factor for impairment, impairment decision is normally based on overall assessment of the borrower's risk profile, pledged collaterals, alternative repayment sources and the potential repayment capacity etc. Therefore, the category of impairment could better serve the intent to recognize riskier loans than the category of past-due loans.

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

- agree