

**Saudi Banks' Comments on the Revisions to the Standardised Approach for credit risk –
Consultative Document**

Bank 1:

Overall comments:

- The bank welcomes the reintroduction of external ratings into the Standardized approach for credit risk, together with the due diligence requirements.
- These two approaches are expected to complement each other in arriving at risk weights, which reflect the true underlying risk characteristics of a borrower. Banks' internal due diligence are envisaged to work as a backstop against inappropriate external rating assignments. Hence, meeting the committee's objective of risk sensitivity and reducing over-reliance on external ratings.
- The bank notes that by nature of being the simpler methodology, the Standardized Approach would logically be less risk sensitive as compared to the modeled capital approaches. The bank therefore suggests reconsidering the Standardised Approach Credit Risk Weight Assets (SA CRWA) as a capital floor for the IRB approaches, which would likely undermine the Committee's aim of increasing risk sensitivity. To support the Committee's aim of increasing comparability across jurisdictions while still being risk sensitive, IRB banks could be required to publish both SA and IRB CRWA and Capital Adequacy Ratio (CAR), with the IRB CRWA being the binding minimum.

Exposure-wise comments

1. Risk weight add-on for exposures with currency mismatch

Trade related transaction banking is a critical global trade enabler. RW add-on for currency mismatch may penalize trade-financing activities and may adversely impact regional or global trade related lending. Although the Committee has proposed an exemption for "natural hedges", the bank recommends that the Committee may also consider specifically exempting trade related financing from the application of risk weight add-ons for currency mismatches. Moreover, additional clarity as to how these risk weight add-ons will interact with the off-balance sheet exposures, post application of credit conversion factors, would be helpful.

It is also recommended that the Committee consider permitting national supervisors discretion in dropping the currency mismatch add-on in jurisdictions, which maintain a currency peg.

2. Project finance (PF) exposures

PF lending in some emerging markets has an impeccable historical performance record. PF structures in these markets entail heavy government support in the form of offtake agreements, termination payments or discounted feedstocks, in addition to

completion support from state owned and/or investment grade companies . This has historically resulted in the creation of extremely low risk PF structures, as evidenced by no defaults during the past 15 years.

PF is a critical source of funding for large core infrastructure, energy and utilities sectors in some emerging markets. The power sector benefits from firm Off-take agreements from state owned utility companies and is not merchant power. Similarly, the downstream hydrocarbon sector is in the lowest cost quartile due to the low and fixed feedstock cost provided by the government, unlike in other economies where feedstock is privately owned and has a variable cost. These specific attributes make PF lending in some emerging markets is significantly different from their peers in other economies, where PF lending has experienced numerous defaults. Hence, assigning a 150% risk weight to unrated project finance exposures during the pre-operational phase and 100% during operational phase may create an excessively punitive capital regime and consequently slow down much needed infrastructure funding in emerging markets. Based on the above, the bank recommends that the Committee consider applying a RW in the range of 60 - 75% (for both pre-operational and operational phases of PF) for the asset class considering the inherent credit quality of PF business in this jurisdiction.

3. Object and commodity finance exposures

Similar to project finance, assigning a flat 120% RW to unrated Object Finance (OF) and Commodity Finance (CF) exposures may result in the creation of excessively punitive capital regime. The recourse in the case of OF and CF exposures is directly on the underlying, hence, the bank recommends that the Basel committee consider a downward revision of RW for unrated OF and CF exposures to 75%.

4. Land acquisition, development and construction (ADC) exposures

It is the bank's opinion that a distinction between Land acquisition ("A") and Development and Construction ("DC") financing should be made. This is due to the fact that Development and Construction financing, unlike Land acquisition financing, is usually done through a PF-like structure that introduces controls, monitoring, and several layers of risk mitigants. This has helped to historically give such exposures in some emerging markets a very low default performance. Hence, for 'with-recourse' development and construction exposures, the bank recommends that the committee consider incorporating a look-up table, based on LTV ratio, such that the RW is in the range of 60% - 75%. Moreover, as this lending is with recourse, the bank suggests that the Committee consider imposing a RW ceiling based on corporate ratings. The advantage of this approach is that it provides one additional driver to fine tune the RW while maintaining simplicity.

Moreover, for non-recourse Development & Construction exposures, or where external ratings are not available, the bank requests the Basel Committee to consider incorporating a lookup table based approach, as suggested above. The bank suggests that the RW in this approach should also be in the range of 60% - 75%. This is envisaged to be more reflective of the underlying risk characteristics than a flat risk weight as we apply lower LTV's for the rare non-recourse transactions.

Moreover, in the bank's opinion, the LTV ratio should be re-calculated to reflect the updated value of the project, once the project is complete and starts generating income.

5. Income Producing Commercial Real Estate – (IP-CRE)

Like development & construction (DC) exposures, IP-CRE exposures benefit from deal enhancements such as reserves, cash sweeps and monthly monitoring and reporting. These result in low risk IP-CRE lending structures. The bank requests that the committee consider a treatment similar to the treatment suggested above for DC exposures, applying the low end of the risk weight i.e. 60% due to the lower risk.

6. Off-balance sheet exposures – General commitments

For general commitments, CCF depends on the maturity of the product [20-50% in case of short term and > 1 year respectively]. The proposed CCFs are [50-75%]. This approach may be overly punitive and may not reflect the actual dynamics of general commitments. It is suggested that the Committee should consider revising the proposed CCFs for general commitments in the range of 20-50%.

Bank 2:

Project Finance:

Increasing the RW of pre-operational phase to 150% will have material impact on CAR.

The proposed risk weights are likely to affect banks from doing project finance business as banks may shy away from taking exposure in PF assets which have higher risk weight. Given the higher risk weight, the appetite of the banks to involve in project finance will diminish, leading to financially viable infrastructure projects being stranded for lack of adequate project financing. In fact reducing the RW to 75% for project finance will help boost economies by enabling project financing.

Object Finance / Commodities Finance:

Increasing RW to 120% should be reconsidered as it will affect the economic growth of certain countries. Banks may shy away from such credit proposals.

Cash in process of collection:

20% RW is assigned. The item is unclear as it is mentioned under Cash item. Needs further clarification.

NPL:

- Unsecured portion attract RW of 150%. The unsecured portion computation should be on net exposure after deducting specific provisions
- If past due exposures are fully secured by collateral with provision amount of 15% of the loan, it is eligible for 100% RW =>. Such details are difficult to implement in an automated environment.

Off Balance sheet items:

- Commitments except retail unconditionally cancellable – CCF @ 50% to 75% => The proposed RW is very much on the higher side. This may not provide incentive to Banks from going for committed facilities in future.
- Revolving Underwriting Facilities (RUF) – Clarification is required in terms of definition and the underlying treatment.

Residential Retail Exposure:

Existing RW is at 100%. Based on the guideline will there be any change in RW for this segment in future?

Commercial real estate exposure:

Existing RW is at 100%. Based on the guideline will there be any change in RW for this segment in future?

Land acquisition, development and construction exposures:

Increasing RW to 150% may lead to avoiding such proposals by Banks, which needs to be reconsidered.

Criteria and triggers for assigning bank exposures to SCRA grades

Grade A

A bank can have loans with e.g. banks from 50 different countries; to read and understand 50 different regulatory frameworks (possibly in different languages) would require time and resources.

1.6 Risk weight add-on for exposures with currency mismatch

Pricing would increase leading to a lower bank's appetite in this area as lending would be adversely affected.

Bank 3:

- 1- The proposed revised Standardized Approach (SA) proposes higher risk weights for Corporate Exposures through the "Look Up" table. This may bring in some

inconsistency throughout the local industry as Banks follow different underwriting standards and thus the assessment of the same exposure may differ from bank to bank. This may result in one bank taking a very conservative view and charging a higher capital while the other bank may not necessarily follow suit.

- 2- A good incentive for banks would be to grow the SME portfolio since the revised SA introduces an 85% Risk Weight for SME's under the Standardized Approach compared to 75% under IRB Approach. This would bring in some capital relief for the banks since SMEs, under current SA, are charged 100% Risk Weight.
- 3- The Recognition of Unrecognized Collateral for SMEs, while this would bring in a risk sensitivity to the SME sector's evaluation, it would be pertinent to know if the BCBS would bring in a similar regime for Corporate Exposure wherein Banks do hold currently Basel Unrecognized Collaterals and thus have to penalize the capital.
- 4- The proposed Risk Weight for Object Financing, Commodity Financing of 120% and 150% and 100% for Project Financing (PF) would put some banks in an advantageous situation. Furthermore, the 100% Risk Weight for PF during operational phase may be difficult to implement since long term projects would take a longer time before generating a Net Positive Cash Flow and also show a declining long term debt.
- 5- Given the proposed new Risk Weight for Equities and Sub-ordinated Debt and Capital Instruments of 250% and 150% respectively, smaller banks may find it challenging to raise capital and / or liquidity through such instruments citing higher capital attraction.
- 6- Banks with significant Real Estate exposures, with the introduction of the Acquire, Develop and Construct (ADC) category would attract higher risk weights thus impairing their appetite to build assets in the Real Estate Sector, which is the country's most significant sector.
- 7- Further clarity is requested on "Unconditionally Cancellable Commitments" since these form a large component of Corporate Exposures and no percentage has been proposed as regards to the risk weight.

Bank 4:

Exposure to Banks and Corporates

- The stated objective of *promoting comparability by reducing variability in the risk-weighted assets across banks and jurisdiction* cannot be achieved under the proposed "due-diligence" approach. The methodology of due-diligence criteria has been left to individual banks, which may result in significantly inconsistent application across the banks. The supervisory guidelines on due-diligence framework may help in ensuring consistency, but the subjectivity inherent in this approach will always result in inconsistent application.
- The criteria and rules suggested for assigning banks exposures to Standardized Credit Risk Assessment (SCRA) approach are also subject to varying interpretation. Similarly, the subjectivity involved in criteria suggested for classifying corporate exposures under "investment grade" may also result in

classifying many entities under this category, since it will attract lower risk weight of 75%.

- The consultative document has mentioned that for bank exposures, CET 1 as a risk driver has behaved consistently with the external ratings and PDS. The bank is of the opinion that the use of CET-1 is adequate and should be continued as a key metric in determining the capital requirements. Moreover, NPA can be replaced with the Leverage ratio. This will help in improving the risk sensitivity and provide a better assessment of the non-risk weighted asset profile of the banks.

Risk Weight of SME under Corporate

- In some markets, SME sector is perceived as a relatively riskier segment. The bank is of the view that lower risk weight for SME than unrated corporate may not be a consistent application for these markets.

Exposure to Retail

- The suggested Loan-to-Value proposal will have its operational difficulties due to reliance on external valuations as well as the consequent burden of additional costs, which will be added to the interest charged to the retail borrowers.

Exposure to Equities, Subordinated Debt and Capital Instruments

- Analysis/reasons which formed the basis of increasing risk weight on these type of exposures have not been made available in the document. The bank is of the view that volatility-based criteria may be devised to make the approach risk sensitive, especially when applying RW in excess of 100%. Increasing risk weight on subordinated debt exposures may restrict banks' avenues to raise Tier 2 capital, and thus resulting in higher cost of capital for the banks.

Unconditionally Cancellable Commitments (UCC)

- Increasing CCF to 50% - 75% appear on a higher side. Usually these commitments represent unutilized portion of limits and the proposed rules will in some cases result in lower risk weights once these limits are utilized. The bank is of the opinion that CCF should be kept at 0%, as banks generally have adequate mechanism in place to cancel such commitments promptly and without recourse to the borrower.

General

- Although detailed impact of proposed amendments in Standardized Approach on banks in some emerging markets cannot be assessed at this stage, however, initial analysis indicate that changes will possibly result in increasing RWAs due to higher proposed Risk Weights for equity exposures/subordinated debt exposures and increase in CCF for unconditionally cancellable commitments. Therefore, the bank is of the opinion that prolonged parallel run period is necessary of existing and proposed approaches before deciding on new set of guidelines.

- The minimum capital floor based on capital adequacy calculated under standardized approach will also result in lesser incentive for the banks to invest in IRB approaches, which in the past has contributed towards enhancing the credit risk management capabilities of banks. This will consequently have adverse impact on bank's risk management practices.

Bank 5:

The Basel Committee's intention to achieve a better balance between risk sensitivity, simplicity and comparability has been retained in the second version and this objective appears close to being achieved. The revised proposals have acknowledged the industry feedback with significant changes made to the approaches under each risk category reducing complexity and recognising challenges that would have been faced in operationalising the proposals.

Whilst the BCBS has indicated that it is not seeking to increase capital requirements, these proposals would appear to have an incremental impact on capital for certain business models, although it is acknowledged the Committee is committed to undertaking a QIS study prior to finalising some risk weights.

In respect of the specific points where the BCBS are seeking industry inputs, the bank have the following comments:

- Section 1.1.1.a External ratings of banks excluding effect of government support:

Currently banks will obtain a consolidated file of all ratings and these would be automatically incorporated into the capital calculation process, selecting the lowest or middle rating depending on how many ratings are available. Therefore, in order for banks to operationalize the use of bank ratings excluding government support, these would need to be made readily available by multiple agencies so as to avoid bias to any particular agency and to avoid the creation of manual review activity in the capital calculation process. Conceptually the use of such ratings is supported.

- Section 1.1.1.b Risk weight floor to capture country risk for unrated bank exposures:

The approach of applying the country rating as a risk weight floor for unrated banks is considered acceptable.

- Section 1.1.1.b Public disclosure of bank's credit assessment approach:

There are already some basic disclosures being made in published accounts and the extension of these is supported subject to the provision of a guidance note and template to allow consistency in the way such information is presented.

Based on the wider changes the bank's comments are as follows:

- Specialised Lending

Whilst the inclusion of specialised lending under the standardised approach fully support the approach of applying flat risk weights which appears to be a missed opportunity. For instance, under Project finance the risk profile of projects being undertaken to support commercial businesses and sponsored by companies is very different to those being undertaken to support government infrastructure and sponsored by the government. It is therefore recommended as part of the QIS exercise to assess the relative riskiness of such projects and to establish separate risk weights dependent on the nature of the sponsor. For example, if the sovereign risk carries a 0% or 20% risk weight then the project finance sponsored by the government would carry a risk weight that is half of the normal level (50% instead of 100% and 75% instead of 150%).

- Cancellable Commitments

The change in approach to unconditionally cancellable commitments is significant and requires very careful consideration to ensure there are no unintended consequences on the operation of interbank markets or trade finance activities. Whilst the drive to increase capital for undrawn portions of funded facilities e.g. Loans and Overdrafts is fully understood and accepted, subject to calibration, the application for off balance sheet and unadvised limits is not supported to the same extent. For operational purposes, banks establish internal credit capacity limits that are loaded onto risk systems and provide flexibility when it comes to undertaking interbank money market placements or other interbank activities, however such limits are discretionary and can be withdrawn at a moment's notice. Similarly, for off balance sheet facilities such as guarantees and trade finance facilities banks establish capacity limits but will assess each request on a transaction by transaction basis. Currently the document requires the application of the lower of the two CCFs for off balance sheet commitments, which would require the same amount of capital as if the entire facility had been drawn, it is suggested to consider applying the product of the two risk weights e.g. if a 20% risk weight for trade and a 50% risk weight for commitments then apply a 10% risk weight.

The reputational risk associated with declining to allow drawdown on a corporate overdraft or retail credit card are very different to not participating in issuance of a performance bond or undertaking activities in the wholesale markets. It is therefore requested that when assessing the risk weights to be applied for cancellable commitments that these are segregated between funded and unfunded limits and differentiated between Banks and Corporates.

Separately, consideration should be given to incorporating and exclusion criteria where the risk weight would not apply, for instance, where credit card limits have been issued and undrawn commitments exist but the customer is unable to access or drawdown on such facilities due to the card being either cancelled or not activated, or the account being suspended due to compliance or other reasons.

- Real Estate

Whilst the approach for residential mortgage risk weights is supported, the proposed risk weights do appear to be on the high side for residential real estate that is dependent on the rental income from the property. Footnote 49 may require reassessment to evaluate the ability of banks to practically implement such conditions where information may not be readily accessible to evidence how many units a person has rented out within the property they live in.

- Lending to High Net Worth Individuals

The document is silent on how to treat lending to high net worth individuals who simply get captured under other retail with a flat 100% risk weight, however the risk profile is likely to be different to that of a mass retail customer.

- Other Retail and Retail SMEs

For retail SME customers that do not qualify for the 75% risk weight it is proposed they receive the same risk weight as corporate SMEs (85%), this would appear to indicate they are lower risk than other retail which are required to receive a 100% risk weight. This treatment does not appear to be consistent with the nature of risk and for consistency it is recommended to consider aligning the treatment at 85% subject to an exposure cap above which a 100% risk weight would apply.

The new regulations will require changes to internal credit risk assessment processes to meet due diligence requirements and also amendments to systems infrastructure that should be factored in the lead time for deployment of the final regulations. It is recommended that the changes needed for sovereigns, central banks and public sector entities are finalised for implementation alongside these rules to simplify deployment.

Bank 6:

1. Currently, the Bank is practicing due diligence criteria over-and-above the availability of external ratings for exposures to Banks. Although relevant, we are of the view that it may impair the objective of promoting comparability by increasing variability in risk-weighted assets across banks and jurisdictions due to its subjective judgment.
2. For “unrated” exposures to Bank asset class, the Bank is of the view that defining the exposure in grades as defined in the document is practical but subjective, and it cannot be comparable across the jurisdictions or even within a jurisdiction by different banks.
3. Similar to the exposure to Banks, due diligence criteria is practical for corporate asset class, however, it may also impair the objective of promoting comparability.
4. As far as changes in CCFs for unconditionally cancellable commitments are concerned, the bank is of the view that CCFs for non-retail commitment are very significant and thus, expect the BCBS to reconsider its calibration.

Bank 7:

The bank welcomes the amendments in the Consultative Document which cover the majority of the significant items that the bank raised in its response to the first consultation paper. However, there is one area that the bank feels has not been addressed appropriately and which has the potential to materially increase capital requirements and impact Large Exposure ("LE") reporting.

Please see below the bank's response to the first consultation paper on this matter.

Off-balance sheet exposures

The bank is of the view that assigning a risk weight to an undrawn, unconditionally revocable facility is fundamentally wrong. The bank accepts that there is a case that it is sometimes hard to decline a customer's request to utilize such facilities. However, the assessment of capital adequacy should be based on exposure at a single point of time across all exposures (and potential exposures). Whilst undrawn uncommitted facilities may indeed be drawn, some proportion of existing exposure will be (p)repaid over the same period. It is, in the bank's view, inconsistent and inappropriate to include one and not the other.

Adequacy of definition of off-balance sheet categories

The bank's concern is with the definition of a "commitment" that is unconditionally cancellable. By definition there is no commitment if it can be withdrawn unilaterally and unconditionally.

If, contrary to the bank's strong belief that this is not appropriate, the BCBS persists with prescribing a risk weight to undrawn, unconditionally revocable facilities, considerably more clarity is required. For instance: does this relate to prospective funded and unfunded facilities? Must the conditions of drawing have been met? Must the facility be advised? Should the facility amount be based on the expected RWA of the drawn amount? The notional? The bank's own determination of EAD?

A further item of lesser materiality with regard to the bank is the Risk Weighting proposed for non-retail SME's at 85 percent. The bank's experience in SME lending to-date does not suggest that this should have a lower risk weighting than commercial lending and that 100 percent should be considered as the minimum.