BASEL III: Request for Comments for the Proposed Revisions to the Standardized Approach for credit risk

Comments submitted by SOMANSHU JEND to the Basel Committee on Banking Supervision (BCBS) for Q21 Part II

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Introduction:

BCBS requested comments[1] for the proposed revisions to the credit risk mitigation framework, applicable to the exposures risk-weighted, under the standardized approach in the section 3 of the Consultative Document on "Revisions to the Standardized Approach for Credit Risk". The author is responding on the Question 21, Part II in this article.

BCBS Question 21, Part II:

Is a 100% risk weight appropriate exposures classified under the proposed "Other assets"?

[1] Revisions to the standardised approach for credit risk - consultative document (link: http://www.bis.org/bcbs/publ/d307.htm)

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Executive Summary

The respondent agrees with the proposal of 100% risk weights, and proposes even an additional charge, total weight 104% to discourage banks from using the "Other Assets" category. This approach will achieve the goals of making the regulatory capital disclosures reliable and robust. The primary goal, of making the reported regulatory capital requirements, reflects the inherent riskiness of the exposures. The secondary goal is to simplify comparisons within the same bank reports or among different banking institutions, while reducing variability in risk-weighted assets (RWAs).

Response:

The goal of making the reported regulatory capital requirements reflect the inherent riskiness of the exposures, while making the Standardized Approach for measuring credit risk, a strong contender to the internal model based approaches. The secondary goal of the proposal is to simplify comparisons within the same bank reports or among different banking institutions, while reducing variability in risk-weighted assets (RWAs).

The respondent agrees with the proposal of 100% risk weights, and proposes even an additional charge 104%. The rationale is, that the proposed weighting will dis-incentivize the banks from using the "Other Assets" category, and will ensure compliance by being available as a last resort categorization. This will discourage any operational/procedural lag in classifying assets or regulatory convenience of giving some buffer to meet the regulatory capital needs.

Although, there may be a genuine business need for this classification, however the committee should provide an incentive in the framework to minimize "Other Assets" and encourage a clear classification to a proposed category with a defined capital charge.

Rationale:

The financial institutions have been very creative in fine-tuning and working around the regulatory capital requirements. Providing an asset classification that fulfills a genuine business need facilitates implementation, however, the classification should discourage a ‘black-box’ asset charge to avoid a higher capital charge.

Given a choice, a risk manager will put assets in a category that gives her access to more capital for business activities; hence resulting in less capital blocked due to the adequacy requirements.

The category “Other Assets” can be used in the following cases:

1. The assets cannot be properly identified in other available categories
2. The value (and/or materiality) of the assets is low enough not to warrant claiming a weight change from 100%, which will be rare unless the asset quality is questionable. In that case a 100% charge is sufficient, because the residual category will be used for the calculation
3. The assets are not significant to be categorized in any available categories

In these scenarios, the regulatory and operational process should be more efficient, supported by the MIS and technology capabilities, to quickly and accurately classify the transactions and the assets after the business event has occurred.

Providing a risk weight of more than 100% will provide a healthy pressure on the banks to minimize the “Other Assets” category usage and use it judiciously, when warranted by the nature of the assets. A charge of more than 100%, or about 104%, may be suitable, because this will highlight the assets true worth to the bank and reflect riskiness without penalizing the true business need of such categorization.

Conclusion

The author agrees with the committees proposal of allowing the "Other Assets" category, and proposes a charge of 100% and upwards. This approach will achieve the desired goals of the regulatory capital requirements reflect true riskiness of the assets, and make the comparison easier and meaningful.

Disclosures:

- The article outlines the personal views of the author, Somanshu Jend.
- All data and disclosures, used from the cited public sources, by the author's and for theoretical purposes only.
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