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By email: baselcommittee@bis.org

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
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Switzerland

Dear Sirs

Consultation Document – Revisions to the Standardised Approach for credit risk

HKAB welcomes the opportunity to respond to the Basel Committee on Banking Supervision's ('the Committee') consultation paper *'Revisions to the Standardised Approach for credit risk'* ('the consultation').

Given the duration that the existing framework has been in place, we consider this review to be timely. We support improvements that ensure its continued robustness, increase risk accuracy and improve comparability across the industry. However, we remain committed to risk sensitivity and for that reason, would be concerned by any aspects of the proposals that would deviate from this ultimate goal.

Following consideration of the proposals, our key observation is that for a number of the material asset classes, risk sensitivity has been reduced through the removal of external credit assessments and replaced with a small number of simplistic risk drivers which are unlikely to be an appropriate fit universally. This requires much further deliberation.

To permit this deliberation, it is essential that banks are allowed sufficient time to consider both the merits of the proposal, the practicalities of operationalising this new framework and to supply data to allow appropriate calibration. With this in mind, we are concerned that the Committee has seen it fit to consult and calibrate the proposals simultaneously, with little consideration of how banks could achieve this.

The proposals published on the 23rd December, represent a step change in the Standardised framework, proposing the calculation of new risk drivers for counterparties based on data, that in large part has not been required historically. Consequently, these data points may not be stored within banks' systems and, where available, would have to be sourced for their entire portfolio, to undertake the impact assessment. For this reason, it might not be realistic, for the accompanying 'Quantitative Impact Study' ('QIS') to be carried out simultaneously.

On the current basis, it would be ill-advised to set the calibration without the appropriate data from banks. This is of particular concern, given that these proposals form a key input to the capital floor that is also under consideration at this time.

On other matters, we have summarised our main comments below and provide further detail, with answers to the specific questions raised in the consultation, in the appendices to this letter.

Reduced reliance on external credit assessments

Since the financial crisis, a number of commentators have questioned the role of external credit assessments in prudential regulation. However, we do not agree that the near complete removal of external credit assessments constitutes an improvement to the Standardised Approach, unless the alternative methodology represents a more robust assessment.

It is also questionable whether issues with external credit assessments were prevalent for the asset classes covered by this consultation and therefore whether such extreme changes are warranted.

The process undertaken by rating agencies constitutes a comprehensive assessment of obligor characteristics which incorporates many hundreds of data points, as well as the incorporation of forward looking considerations. To replace this with an assessment based on two risk drivers derived from data which could be very out of date does not appear to meet the Committee's objective of increased risk sensitivity and, would in fact, reduce it.

A more progressive solution would be to retain the use of external credit assessments and to improve the framework through increasing the number of possible risk weights, reviewing the associated calibrations and focusing on a new approach for unrated obligors, which could include, but should not be limited to, the risk driver methodology proposed in the consultation.

Calibration

Although the consultation states that increasing capital requirements under the Standardised approach is not an objective, given the range of proposed risk weights, it is difficult to envisage a different outcome. For example, the introduction of risk weights which transition from 20% - 150% to 30% - 300% and 60% - 300% for banks and corporates respectively, is without supporting justification. While theoretically, these could be partially mitigated by reduced risk weights in other asset classes on balance this outcome is unlikely.

Also the introduction of Specialised Lending treatment, for which the proposed risk weights transition from 70%-150% under the Foundation IRB Slotting Approach to the proposed 120%-300%, appears to be a case of mis-alignment in calibration between the supervisory prescribed approaches.

Overall, it is not evident how the proposed risk weights link to observed credit risk. Consequently, the incorporation of the outcomes from an appropriately considered QIS will be key to a successful framework and appropriate calibration..

Implementation

While the risk drivers proposed may appear to be commonplace they are not universally present in banks existing risk engines and capital processes and in some instances may not even be available.

In the case of the risk drivers required for *banks* and *corporates* the source data, even where collected at source and analysed for risk management purposes, is not currently feeding the current capital calculation for Standardised exposures. In other examples, the risk drivers for *banks* include a *Non Performing Asset* variable not currently disclosed in a mandatory or consistent manner in banks' Pillar 3 disclosures. The latter would require revision to accommodate this.

Therefore significant data, system and disclosure changes would be required to implement the proposals. Given the unprecedented level of regulatory change that banks' currently face, a suitable implementation timescale of at least 3 years plus would be necessary, to allow systems, processes and disclosures to be updated. This is particularly true in light of the complementary proposals on capital floors which

would require Standardised RWAs to be calculated for all exposures, regardless of whether they are calculated on IRB approaches.

Inappropriate risk drivers

Without understanding the method by which the Committee selected the proposed risk drivers, it is difficult to comment definitively as to their appropriateness. However, our initial view is that some of these could benefit from further consideration.

One particular concern relates to *'exposures secured by residential real estate'* ('residential mortgages') where the risk indicators incorporate valuation and income measures that are fixed and remain static, from the point of loan origination. While we understand the need to retain some measure of stability in capital calculations, the fixing of these values at origination reduces their very merit as a risk driver and does not solve the issue of procyclicality given the valuation is taken at a specific point in time which varies for each individual asset.

Additionally for *'corporates'*, there is significant concern that the use of revenue and leverage metrics will not adequately reflect risk across multiple industries and jurisdictions. In general, it is also questionable how relevant and appropriate these risk drivers and associated splits hold within a global framework and alternative drivers should therefore be considered. Other risk drivers may be appropriate, such as asset size, debt service/interest cover, country, industry and life cycle. For Bank exposures, the inclusion of CET1 ratio as a risk driver, which is in turn dependent on the IRB approach and the internal models adopted by the obligor bank, is also contradicting the objectives in particular Principle 4 in Section 1.3 – "Principles and rationale of the review".

The addition of risk drivers and the increased level of granularity may add to risk-sensitivity, but it does not automatically make the risk-weighting more risk sensitive. Risk drivers that may not necessarily be relevant or would have to be calibrated differently by jurisdiction or by industry, may only result in a false sense of comparability.

Reduction of national discretions

We agree that in a number of areas the standardised approach could benefit from a reduction in complexity and would support the aim to reduce the amount of national discretions. Given this, the rationale behind the retention of certain national discretions is unclear, such as the 50% risk weight applied under option A of the commercial real estate proposals.

Approach design

Setting aside the use of external credit assessments, the concept of introducing risk drivers in the allocation of RWAs, as a replacement of the flat risk weights in the current approach, would increase risk sensitivity.

Although the Committee does not view the approach set out in the consultation as being akin to a risk model, in effect, it does constitute the characteristics of a simple risk model and has been designed using typical modelling methodologies. With that in mind, it would be insightful for the Committee to elaborate upon the process by which the candidate risk drivers, characteristic splits and final risk weights, have been determined. It would also be useful to understand how the Committee intends to utilise the data supplied with the QIS to further inform this process.

Conclusion

While we agree that a review of the standardised approach is welcome, the proposals do not constitute an advancement in risk assessment and will potentially result in significantly increased capital requirements while less accurately reflecting the underlying risks. They could also have the unintended consequence of significantly constricting lending to SMEs which are crucial aspects of sustainable economic growth.

In conclusion, the changes proposed in the consultation are considerable and it is vital to ensure that the resulting framework is appropriate, not only for Standardised banks, but also for IRB banks through their Standardised exposures and through the implementation of the proposed capital floor. Any impacts need to be considered holistically, looking across impacts on the levels of Basel III capital buffers, Pillar 2 add-on and TLAC – the calibration of which would require review following any structural shift of risk weights as a result of a change in the regulatory framework.

We hope you find our comments useful. For any questions, please do not hesitate to contact Ms Emily Ngan of the Secretariat at (852) 2526 6080.

Yours faithfully

Henry Chan
Secretary

Enc.

c.c. Ms Karen Kemp, Executive Director (Banking Policy), Hong Kong Monetary Authority

Appendix I – ***Proposed revisions to the standardised approach for credit risk:*** **Responses to the specific questions**

(2.1) Exposures to banks

General comments:

- Risk weights under the current standardised approach range from 20%-150%. Although it is not evident how the proposed risk weights have been calibrated it would seem a logical conclusion that RWAs could only increase under the consultation, which is not a stated goal of the revisions.

- The replacement of external credit risk assessments with a two risk driver model actually reduces risk sensitivity and may result in risk weights being intrinsically outdated due to lags in publication. We would suggest that the use of external credit assessments, where available, is likely to remain the most appropriate basis for a risk weighting.

- Banks would require a suitable implementation period as sourcing and storing of Pillar 3 data may not currently be part of banks' relationship management process.

- We would note that banks' solo Pillar 3 reporting may be produced on an infrequent basis. For the sake of consistent application it would seem more appropriate to use consolidated Pillar 3 in all cases.

- The new definition of 'banks' now directly references 'deposit taking', which will greatly reduce eligibility for this classification (i.e. insurance companies etc. now being classified as either corporates or banks with risk drivers that are not publicly disclosed or published within the frequency as required by Pillar 3 disclosure standard), causing a shift of exposures to corporates and associated higher RW%.

- Under the proposed standardised approach, the data disclosed in recent Pillar 3 reports must be used for risk weighting bank exposures but corporate's year-end accounts for the most recent financial year available should be used for corporate exposures. This could lead to different update frequency of risk drivers and risk weights between credit exposures to banks and corporates. We suggest to align the time spectrum for risk drivers used for exposures to banks and corporates. To accommodate the one year time horizon for capital management, financial year-end update is appropriate for both bank exposures and corporate exposures.

- Referring to para 19 of Annex 1, financial firms would be treated as exposure to banks under the condition that they are subject to prudential standards and similar supervision as banks. Some insurance companies and securities firms may be treated as exposures to banks. Our concerns are that these risk drives (CET1 ratio and NPA) are neither available nor appropriate to determine the risk weights of these institutions. We suggest the Committee to explore other ways to determine the risk weights for Securities Firms and Insurance under the proposed New Standardised Approach if external rating is removed.

Q01: 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?

The use of CET1 ratio does not appear to be an appropriate basis for assigning risk weights. Within the CET1 ratio used, the denominator of the ratio would be subject to the approach adopted by each obligor bank (e.g. Standardised/IRB), which this consultation and the complementary capital floor consultation bring into question, as well as current standardised RWAs which the Committee acknowledge are flawed and which this consultation seeks to replace. It seems incongruous to replace the mechanistic reliance on external credit ratings with a mechanistic reliance on legacy RWAs. Although this influence would reduce over time the leverage ratio would at least not suffer from this seemingly circular weakness.

While a level playing field is crucial to better comparability, currently Basel III has not been introduced everywhere and where it has, national implementations can differ (e.g. different capital buffers regimes and transition schemes). This is true in both the calculation of the numerator and denominator of the CET1 ratio. It is not clear then how a level playing field will truly be achieved.

In our view, the real issue during the Global Financial Crisis was liquidity triggered by concerns regarding capitalisation and asset quality. We would suggest reviewing the use of external ratings, as these comprehensively combine capital, liquidity and asset quality in a single, consistent metric.

On this note, we want to raise the concern, that the proposed risk-weighting grid turns the 12% CET1 ratio (Annex 1 Para 13) into the new capitalisation target for banks for achieving lower RWAs. This is inconsistent with the Basel III concepts, which define a capitalisation range subject to economic conditions and size of banks.

Q02: 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?

The use of the net NPA ratio as defined would be susceptible to institutional and jurisdictional provisioning policies and non-universal application of the new IFRS 9 so it is difficult to envisage how a level playing field could be achieved. Impairment is a lagging indicator. Rapid lending may reduce the ratio, but expose the bank to greater risk, especially in a weak environment. Conversely, a bank that slows lending or deleverages will most likely see the ratio increase, even though it is cleaning up its book and tightening its lending criteria. As such, reliance on this lagging indicator would lead to inappropriate risk weights. It is not forward looking. This may lead to heavy reliance on the public information disclosed by the counterparty banks.

We note that the Committee intends to work on this to ensure this is neutralised and would suggest this was key to the success of this particular risk driver. Additionally, it is unclear why the NPA ratio would be included over and above other candidates, given the credit risk would already be represented in the CET1 ratio.

Q03: Do respondents have views on the proposed treatment for short-term interbank claims?

The proposed treatment has the potential to result in disruptions to the inter-bank liquidity markets. Therefore, the condition "expected to be rolled" should be clarified and must not be re-identified based on "average" outstanding. The preferred treatment should be made available to inter-bank liquidity transactions and placements.

Q04: 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?

It would not seem appropriate to implement a system where banks required their obligors, who were not utilising Basel III for their own capital, to calculate and publish metrics on a Basel III basis, as it would be unduly burdensome. Given local regulators would not verify how this were achieved and lending banks would not have the insight, skills or authority to oversee this, it would also not appear to be prudent. The risk-weighting would be better based on external ratings, as these ratings capture capital, liquidity and asset quality of financial institutions, and would also help to overcome the differences between funds, insurances and banks that would be clubbed together under exposure to banks.

Given all the issues outlined above and the fact that bank ratings did not really suffer from the same weaknesses as ratings on structured notes and sovereigns, we suggest that the external ratings-based approach be retained for bank exposures. Risk weights for unrated banks should follow the current Basel II Option 2 approach for bank exposures, i.e. risk weight based on external rating of sovereign. (Basel II document Para 60)

(2.2) Exposures to corporates

General comments:

- Risk weights under the current standardised approach range from 20%-150%. Although it is not evident how the proposed risk weights have been calibrated it would seem a logical conclusion that RWAs could only increase under the consultation, which is not a stated goal of the revisions.

- The 300% risk weight that is applied in instances where risk driver information is not available appears unduly punitive and does not appear to be in line with the Committee's objectives around capital impact neutrality. It may also restrict lending within the SME market.

- The replacement of external credit risk assessments with a two risk driver model actually reduces risk sensitivity and may result in risk weights being intrinsically outdated due to lags in publication. We would suggest that the use of external credit assessments, where available, is likely to remain the most appropriate basis for a risk weighting.

- The consultation is non-specific as to whether metrics should be based upon a consolidated view of the obligor or legal entity basis.

- Bank systems may not currently be designed to support the proposed changes, and revenue and leverage information may not currently feed into their risk engines. The proposal would require significant data, system and disclosure overhaul to implement. For example, new start-up companies without year-end revenue data would carry 110% risk weight (rather than 300% if the data needed to calculate revenue and leverage are not available) and systems enhancements would be required to distinguish such new start-ups.

- Unlike banks which are highly regulated entities, the requirements of financial statements (e.g. type, frequency, auditing status) for corporates based on which the risk factors are to be sourced vary to a large extent. This is particularly true for SMEs / non-listed companies and for emerging markets, and thus raises concerns with the practicality of getting the risk drivers from a standardised and reliable source, which is prone to subjectivity when it comes to implementation.

- Referring to the footnote 16 of the consultation which states the bank should begin to use the financial statements from the same month when the corporate published them to calculate capital. This proposal would not seem to be feasible as it does not take full consideration of banks’ practice in collecting corporate customers’ accounts and performing credit review. We suggest that at least 4 months' grace period should be given to banks to collect corporate customers' accounts, and complete a credit review to ensure data quality.

Q05: 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 and leverage would undoubtedly form part of an internal credit assessment for corporate counterparties. However, we have concerns that their choice as risk drivers would not be appropriate in the design of a global approach and would be susceptible to differing local accounting practices. We agree with the fundamental issues with the drivers that the Committee has identified, specifically that the splits would be inappropriate across all industries and jurisdiction, and believe that this actually weakens them as suitable risk drivers.

We have particular concerns about how the inclusion of Revenue, which is purely a reflection of size, has been incorporated into the framework in a manner contradictory to other areas of the capital framework and will unduly penalize SME counterparties. We recommend that turnover is removed from the framework.

The incorporation of off-balance sheet exposures into a leverage calculation would also be resource intensive, costly and operationally difficult and the measure of Leverage being a part of the rating framework will be most susceptible to provisioning practices. It is unclear how the Committee has determined the current risk drivers and we would suggest that other risk drivers may be more suitable. Candidates that should be considered if the use of risk drivers continues would include, but not be limited to, net tangible assets and interest cover, both of which are likely to be more appropriate as part of a global framework. In addition, Liquidity and Performance are two other risk factors commonly used in credit assessment for corporates. However, we would note that it is impossible to properly reflect nuances of all global corporates in a simple 2 risk driver approach. In particular, on the assumption that revenue is a proposed driver, it may not differentiate effectively between industry sectors, for example between a manufacturing and a trading customer. It may not capture the different risks associated with different facility structures within a global and trade receivable finance portfolio. There may be other more appropriate drivers of risk in different markets.

Whilst the definition of leverage is not clear, there may be different market norms and/or ability to finance leverage across jurisdictions and industry sectors. The approach may not reflect the lower risks associated with the availability of tangible security. The taking of security is normal practice within a number of product offerings within Hong Kong SME portfolios.

We suggest that the use of external credit assessments, where available, is likely to remain the most appropriate basis for a risk weighting. We would encourage the Committee to retain external credit assessments, increasing the number of available risk weights, and look for alternatives for unrated counterparties (including SMEs) such as, but not limited to, revisiting the choice of risk drivers as detailed above.

The proposals in the consultation document are quite simple and assume that all corporates across jurisdictions and across industries can be assessed using a single set of metrics. We therefore suggest using benchmarking data to review the selected set of metrics and their calibration.

Q06: 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?

We recognise that the Committee has been conscious of the treatment of SME counterparties in the design of the approach. We see some merit in a concession for start-up companies although it is difficult to align the beneficial risk weight, from 300% to 110%, with any risk assessment.

We would recommend a review of the migration of risk weights across exposure classes to ensure it is coherent; currently as a small business grows it could move from 75% (retail) to 110% (start-up) to 300% (corporate with no account information), with no discernible change in risk.

One possibility would be to limit the Retail category to non-business lending, putting small business lending into the Other Retail category whilst also reviewing the severity of the 300% risk weight for smaller corporates. In this way cliff effects caused from migration from Retail to Corporate would be mitigated, assuming a neutral leverage impact. Any preferential risk weight that is retained should be extended to the 'submission' of the companies first set of results in view of the fact that a large number of start-ups will not submit accounts within 1 year.

SMEs, particularly in emerging markets, are unlikely to produce the necessary risk drivers and would therefore receive a risk weight of 300% in many cases. This may lead to the unintended consequence of constricting lending within the SME market. Given the role of SME lending as a source of economic development, this may not be appropriate. Also this appears to be misaligned to the firm-sized adjustment under IRB. We urge the Committee to consider allowing preferential treatment on SMEs so as to align the treatment in IRB.

Q07: Do respondents think that the risk sensitivity of the proposal can be further increased without introducing excessive complexity?

While the inclusion of additional risk drivers might improve the risk-sensitivity of the proposed methodology, it would increase the burden for less sophisticated, smaller banks and would potentially undermine the objective of comparability. We would encourage the Committee to retain external credit assessments, increasing the number of available risk weights, and revisit the choice of risk drivers as detailed above and limit the use of these risk drivers for unrated counterparties. Although this may further increase complexity, it would be a smaller change from the current methodology and would be an improvement in terms of risk sensitivity.

Q08: Do respondents agree that introducing the specialised lending category enhances the risk sensitivity of the standardised approach and its alignment with IRB?

We agree with the introduction of a new category and bespoke treatment for specialised lending exposures. However, we are not of the view that this has necessarily been achieved with this proposal.

The flat risk weights proposed as a starting point for specialised lending exposures appear highly penal, are without supporting justification and do not separate assets with differing underlying risk. They ignore the nature of the loan structure and the appropriateness of the relationship between the asset and loan risk.

The current proposals would not appear to be suitable as in a large number of cases the nature of specialised lending counterparties would mean that the required risk drivers were not published. This would lead to risk weights of 300% being applied on a frequent basis which would not be reflective of the underlying risk. The current approach of using the same risk drivers as the corporate for specialized lending exposures is inappropriate given the nature of the entities under this category (e.g. typically SPVs) and how their credit worthiness and repayment capabilities are typically assessed, i.e. relying more on the future cash flow projection, asset/project characteristics etc. of the underlying assets / projects rather than the historical financial performance which is either not available or non-existent in most cases. One option would to look to align to the IRB supervisory slotting, in entirety or part, as the information available to categorise a counterparty into its appropriate slot, would be more readily available. This would lead to significantly more appropriate risk weightings and greater alignment with IRB.

It would also be beneficial to directly align the definitions of specialised lending between the standardised and IRB approaches.

(2.3) Subordinated debt, equity and other capital instruments

General comments:

The introduction of the revised risk weights will introduce a seemingly illogical element to the risk weights applied to investments in financial sector entities. Currently, under the current standardised approach, exposures are risk weighted at 100% unless they are directly deducted from capital or risk weighted at 250% through threshold deductions of significant investments in financial sector entities. While we recognise that this risk weight may require review, it appears illogical that non-significant investments in financial entities will receive a risk weight of 300% of 400%, whilst some significant investments will receive a risk weight of 250%.

(2.4) Retail portfolio

General comments:

- It would be more coherent to ensure one definition of retail customer is used across IRB and Standardised frameworks.
- As described for corporates, in order to avoid cliff effects and to allow for more logical risk weight migration across exposure classes the Committee should reconsider the treatment of small businesses under both the retail and corporate exposure class.
- It is unclear how the national discretion in the definition meets the Committee's objectives.
- Further clarification would be helpful with regard to the retail definition specifically with regard to how sole traders and individuals involved in an enterprise meet the definitions of individuals and small business.

Q09: 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?

We are of the view that there is no universal risk driver that would be consistently appropriate across jurisdictions. However, it is unclear why the Committee does not believe that the 'Debt Service Coverage' ('DSC') risk driver that is suggested for residential mortgages would be any less appropriate in this case.

We would suggest reviewing the use of more granular risk drivers, as a single risk-weight of 75% respectively does not allow for risk differentiation. For example, for credit card portfolios and personal loans we would suggest to consider the use of day past due information.

(2.5) Claims secured by real estate

General comments:

- It is unclear how the national discretions meet the Committee's objectives.

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

It is generally accepted that LTV and affordability, in this case measured by the DSC, are variables highly predictive of loan default. However, there are significant concerns as to their appropriateness in a globally consistent framework as outlined in the consultation.

In the case of LTV there can often be significantly different average levels of LTV, as well as frequent nuances in the calculation, across jurisdictions. In certain countries, the regulatory policies in force would render the prescribed LTV buckets less effective / less appropriate. In Hong Kong, the maximum LTV allowed for Residential Real Estate is 70%, unless extra insurance is acquired to cover the borrowings beyond the 70% LTV. The six buckets Risk Weight for the LTV ratio is in effect reduced to three or four in this case. While this would not necessarily rule out LTV as a suitable candidate it does call into question how comparable and meaningful outputs across jurisdictions will be.

For DSC there is likely to be wide variation across jurisdictions with regard to income disclosures. It would be difficult to capture DSC for all markets. Often true income levels are difficult to ascertain as elements of customer income are difficult to determine or are simply not declared. In emerging markets, the capabilities to assess the net income of a customer are less developed. In markets where financial services and credit bureaux are less established, the ability and potential to capture debt obligations with other lenders is difficult, and income data date back to the time of origination for historic applications does not stretch further than a few years, which limits the calculation of an accurate DSC ratio. In certain jurisdictions this has led to income based variables proving difficult to correlate with default, irrespective of how intuitive this relationship would appear.

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.)

The proposal to fix both LTV and DSC at point of origination completely invalidates their candidacy as risk drivers for the life of the loan. Both metrics should be adjusted over the lifetime of the exposure. In line with banks' own risk-management practice, banks should be required to determine LTV and DSC at the point of reporting. Incomes can vary wildly across the average residential mortgage term, including through job losses, retirement or changes in household structure. As well as this, interest rates on all variable rates products can vary dramatically. In addition negative equity is, in certain markets, one of the primary drivers of default in residential mortgages and over the term, often as long as 35 years, an inconsequential mark to market LTV could still result in a relatively high risk weight due to the fixed valuation. Ignoring these variations would result in a meaningless risk driver.

Current LTV is likely to be more predictive than origination LTV; however, any valuation taken at a single point in time is likely to introduce procyclicality into the framework. Investigation into a suitably cycle neutral valuation should be undertaken to attempt to mitigate these effects, being mindful of the practicalities of such a measure within a globally consistent framework. Given the concerns regarding the practicalities of DSC both the current and cycle-adjusted LTV could be considered simultaneously.

Also the lack of updated property valuation seems to be at complete odds with current credit risk mitigation rules around revaluation of collateral which require updated collateral values at least every 3 years and more frequently in specific circumstances. This disconnect in treatment will allow changes in RWAs to be reflected in a changing credit risk mitigation purposes under IRB, but will not allow reflection in the Standardised risk weights. While origination and current valuations introduce different elements of the cycle, the eligibility rules, as well as treatments across approaches should at least be reflected consistently. In addition, should origination

LTV continue to be used as part of the framework, more detail would be required as to how this would be calculated to ensure an appropriate implementation. For example, how should application fees be treated, how should remortgages with the same lender be treated, would purchase price or valuation be used? Would banks be allowed to use index-based methods for determining LTV? Policies around such questions will often vary for institutions within the same jurisdiction, let alone across jurisdictions. For any variable to be useful it would need to be comprehensively defined.

In the case of the debt that is considered as part of the DSC calculation this would appear to penalise institutions operating in jurisdictions with developed credit bureaux, who will automatically have more insight into a customer's debt burden – conversely this may make judgements in jurisdictions without developed bureaus relatively imprudent. This could be compensated for by institutions own transactional data which would allow them to reliably calculate disposable income or affordability of an obligor; however, again this would penalise institutions with more rigorous affordability assessments.

The definition of financial obligation would also need to be more comprehensive as to whether only contractual obligations are relevant or if informal obligations should also be included. In addition, clarity on how interest only mortgages should be considered given no contractual principal payment would be due, but where provision for a repayment vehicle would be prudently required. For all variable rate products, it is unclear if the origination DSC would be suitable, as the debt service ratio would change with rate changes. In addition, the definition / calibration of debt measurement and income measurement for purposes of DSC calculation should be standardised and consistently applied across banks and jurisdictions in order to ensure comparability and level playing field.

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?

Notwithstanding the concerns raised about appropriateness and calculation of the proposed DSC variable the fixed threshold does not appear to be wholly inappropriate. However without further information around how the split was determined it is difficult to comment further. It is likely that this threshold could be very meaningful in some jurisdictions and completely meaningless in others. We are concerned that setting a fixed ratio will inevitably turn this single ratio into a new lending standard.

Q13: Do respondents propose any alternative/additional risk drivers for the Committee's consideration in order to improve the risk sensitivity in this approach without unduly increasing complexity?

We are of the view that a suitable candidate variable that would work across all jurisdictions will be very difficult to determine. Possibilities would be to investigate incorporation of loan purpose (owner occupier vs buy-to-let) or repayment vehicle (capital repayment vs interest only with potential to drill down further to repayment source).

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?

Both treatments suggested suffer from weaknesses which ultimately will not result in an appropriate treatment for Commercial Real Estate exposure, meaning we would not support either option as currently proposed.

Treating exposures to commercial real estate as unsecured, as proposed in option A, with the same RWA treatment as standard corporates would not be suitable given the presence of collateral. However, we do not support option B where RWAs are assessed purely on the basis of a point in time LTV measure. Any valuation based on market value at a specific point in time, is simply the estimated amount for which real estate would change hands between a willing buyer and seller in an arm's length transaction, after proper marketing and where the parties had each acted knowledgably, prudently and without compulsion. It is not therefore an objective measure or a strong indicator of long term risk.

If the Committee pursues the options suggested, additional clarifications and amendments would be beneficial. If option A is retained the concession for well-developed and long-established markets is welcome, however, the lack of a specific definition of well-developed and long-established markets is not ideal.

It is also unclear how the retention of a national discretion in this area is in line with the Committee's objective to improve comparability. It is suggested any concessionary risk weight should not be implemented as a national discretion but should be codified in the framework itself. If option B were chosen it is unclear as to whether the LTV would be based upon origination valuation as per the proposals for residential mortgages or on another valuation.

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

We would suggest that a version of the slotting approach should be considered as the basis for a risk weighting all Commercial Real Estate. An alternative to this would be to look to combine the proposed options so that both the underlying corporate and a bespoke underlying risk driver were considered in the allocation of the risk weight. In this way the corporate risk weight could be adjusted by, or combined with, an assessment based on debt yield or a cycle-adjusted LTV. Both options could be implemented without undue complexity but would greatly increase risk sensitivity.

(2.6) Risk weight add-on for exposures with currency mismatch

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?

If a risk weight add-on is deemed appropriate it would appears logical to only apply this to retail and residential mortgage exposures.

When considering risk weight add-on for exposures where the currency of the loan is different from that of the borrower's income, currency convertibility and transferability should be taken into account. For example, the proposal applies add-on but neglects the benefit of when the currency of borrower's income appreciates against the loan currency. It is not clear why an add-on is necessary in such case. In view of both negative and positive effect on obligor's debt servicing capacity, this risk weight add on appears to be biased and not appropriate to be applied all the time.

(2.7) Off balance sheet exposures

General comments:

We would welcome the alignment of CCFs across approaches as there seems limited basis for differentiation. We would not support harmonization at the cost of risk sensitivity. However, for unconditionally cancellable items it is unclear how the proposed 10% CCF is derived and further evidence to support this would be insightful. The amendment to 10% appears punitive given limits can be cancelled unconditionally and further insight to explain this would be welcome. We would note also, that unconditionally cancellable items will still not be consistent given it will remain at 0% for Foundation IRB.

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

Yes, we agree that the definitions are adequately defined though we do not support the application of a 10% CCF for unconditionally cancellable undrawn commitments. In our experience, such commitments are managed pro-actively and in consideration of counterparty's credit risk, and have not resulted in significant risk exposure.

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.

The proposal to remove maturity from the application of CCFs for conditionally cancellable commitments reduces risk sensitivity and appears punitive. While the 75% CCF has been proposed to bring it in line with the IRB foundation approach, there is no rationale provided as to why the 75% CCF is the most appropriate outcome.

(2.8) Past-due loans

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

We see no intrinsic issues with the current approach for calculating risk weights for past due exposures. As such we are not supportive of a flat risk weight and would continue to support a framework that accounted for the level of provisions held against past-due exposures. The option of a proposed risk weight add-on to an applicable risk weight is very unclear and we can make no comment on such a treatment; it would be insightful for the Committee to elaborate on this option further in order to assess its merits.

We would welcome alignment between the definition of past-due loans under standardised and definition of default under IRB.

(2.9) Exposures to multilateral development banks

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

It is unclear why the Committee feels the use of external credit assessments, which have been removed in other exposure classes, is appropriate in this case. We believe it would also be beneficial to provide a specific list of MDBs who meet the "Qualifying MDB" criteria in the same manner as for "Highly rated MDBs" on a regular basis; this would ensure consistent implementation of the criteria (i) to (v) as set out in paragraph 11 (a) of Annex 1 of the consultative document. Finally the fall-back treatment of treating MDBs as corporate would be unduly punitive, given the maximum 150% risk weight applied to the worst rated qualifying MDBs. We would suggest a 150% risk weight for "Other MDBs" in line with the worst rated qualifying MDBs.

(2.10) Other Assets

Q21: What exposures would be classified under "Other assets"? Is a 100% risk weight appropriate?

We do not agree that a 100% risk weight is appropriate for the starkly different items that could fall into this category; for cash in hand and gold bullion a 100% risk weight would not appear appropriate. (Under Basel II document Para 81, cash in hand and gold bullion can be assigned with 0 % risk-weight at national discretion.) We would encourage a full assessment of other items is undertaken by the Committee to ensure consistent and appropriate implementation. As a starting point, under the current standardised approach there is a list of items that can be reported in the equivalent asset class and this would appear to be a more appropriate treatment. The 100% risk weight could then act as a fall-back value if an item is not specified.

Appendix 2 – *Proposed revisions to the credit risk mitigation framework for exposures risk weighted under the standardised approach:* Responses to the specific questions

(3.2) Eligible financial collateral

Q22: What are respondents' views on the above alternative ways to define eligible financial collateral?

The definition as written is unlikely to result in a consistent application as part of a global framework. For example, we would not recommend to use the concept of "Investment grade" to determine the eligibility of financial collateral. The proposed methodology requires due diligence and additional analysis on the collateral, however, which are not clearly defined in the consultation. The proposed concept of "investment grade" is a subjective measurement and thus is not suitable for Standardised approach and may not be a better indicator than external rating.

We do not support the idea to remove the external credit rating requirement for eligible financial collateral, and the references to external credit ratings in the supervisory haircuts table. As the consultation document points, this is a "second-order" issue because references to external ratings in this context does not directly determine the risk weights. In addition, as pointed out above, external ratings are still used in the Basel securitization framework and in the proposed new market risk framework.
Eliminating all references to external ratings in credit risk mitigation is not necessary. It will just lead to unnecessary complexity (e.g. how will supervisors ensure that "investment grade" will be consistently defined in practice?) without any clear benefits.

A possible way to improve this definition would be to incorporate external credit assessments but purely on an illustrative rather than mechanical basis.

With the implementation of Basel III, banks are encouraged to issue capital instruments that are classified as debt but which can be written down or converted to equity when certain regulatory requirements are met. These capital instruments usually are sub-investment grade. As such, this kind of capital instrument could not meet the requirement for eligible financial collateral according to the supervisory haircut as set out in paragraph 108 of Annex 1. However, if these capital instruments are converted to equity and the shares are listed on recognized exchange, they would become eligible financial collateral. Therefore, we consider that it is punitive to disallow this type of capital instrument for credit risk mitigation purpose before they are converted to equity. We urge the Committee to consider this type of capital instrument to be classified as eligible financial collateral.

Q23: What are respondents' views on the recalibrated supervisory haircuts shown in Table 4? What are respondents' views on how to eliminate references to ratings from the supervisory haircuts table? What could be the implications of eliminating references to external ratings?

As previously commented removal of external ratings would not seem to improve the overall framework. The alternative supervisory table based on risk weights implies that institutions would need to calculate risk weights for counterparties that were not necessarily obligors, but whose debt was being offered as collateral, which would not seem to be workable framework.

We suggest reconsidering the use of external ratings for determining supervisory haircuts given these comprehensively combine capital, liquidity and asset quality in a single, consistent metric.

We would also like to clarify if the haircut figures in Table 4 should be expressed as percentages, and suggest the same presentation format be applied consistently throughout the document on similar tables such as Table 5 and the table under paragraph 108 of Annex 1.

(3.3) Eligible credit protection providers

Q24: What are respondents' views on the proposed corporate guarantor eligibility criteria?

As previously commented removal of external ratings would not seem to improve the overall framework. The suggested criteria may be appropriate as additional criteria for use where external credit assessments are not available however, the definitions would need to be more strictly defined. However, it should be noted that under the consultation we would be required to collect risk driver information for all guarantors in order to calculate a risk weight, which would not seem to be workable framework.