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By email: baselcommittee@bis.org

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Dear Sirs

BCBS Second Consultation on Revisions to the Standardised Approach for Credit Risk

We refer to the Second Consultation on Revisions to the Standardised Approach for Credit Risk issued by the Basel Committee on Banking Supervision (BCBS) in December 2015.

On behalf of our members, we set out in the annex our detailed comments on the proposals in the consultative document.

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

Doris Ma
Secretary

Enc.

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

Annex

Comments on BCBS Second Consultative Document on "Revisions to the Standardised Approach for credit risk"

Sequence number	**Section / Annex of the document to which the comments refer**	**Paragraphs and / or extracts of the document to which the comments refer (including page number)**	**Comments**
1.	Main body; Section 1: Proposed revisions to the standardised approach for credit risk	**Section 1.1.1 Exposures to banks** (a) External Credit Risk Assessment Approach (ECRA) *(Page 4-5)*	• The risk weight is first determined by a look-up table based on the external rating. However, the emphasis is placed on the bank's due diligence assessment on each counterparty, so as to avoid mechanistically relying on the external ratings. While we agree with the underlying principle of the proposal, this may be less relevant to the existing IRB banks which will be required under the IRB framework to assess the credit rating of individual counterparty using their internal rating models that have been reviewed and approved by the regulators. For the IRB banks, the use of Standardised approach mainly serves the purpose of capital floor calculation, and we consider the existing process of generating internal ratings a sufficient evidence of the due diligence required under ECRA. • On the requirement that "due diligence analysis should never result in the application of a lower risk weight than that determined by the external rating", we propose that the IRB banks may demonstrate the compliance via comparing the risk weight mapped by the external rating and that from the internal rating systems, and adopt the more conservative one for capital calculation under the

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			Standardised approach. • The due diligence process of the banks in the absence of any clear guidelines under the revised proposals will vary and credit risk assessments of some banks may not be as sophisticated as the ECAI's analysis. So overrides to the external ratings by these banks may not correctly reflect the risk sensitivity. For banks with stronger risk assessment capabilities on the other hand, the floor based on external ratings could be punitive, as the external rating agencies do not necessarily have superior assessments methodologies. • The variability in what due diligence could entail in different institutions has the potential to result in a lack of transparency and comparability in institution's RWAs. We would urge the committee to consider the following alternatives: ➢ not to adjust ECAI ratings at all; ➢ require all banks to use external ratings from more than 1 ECAIs so as to avoid reliance on a single ECAI and at the same time to obtain more than one credit assessment of the same counterparty; ➢ consider to provide "PD to External Rating" mapping which allows IRB banks to assess whether external rating is appropriate in comparison to the internal rating. There could be higher

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			comparability in institution's RWAs if the "PD to External Rating" mapping is provided by the committee. • For the requirement of excluding the consideration of implicit government support in using the external ratings, we are of the view that unless such ratings are explicitly stated / published separately by the rating agencies for all banks rated, it would be difficult if not impossible to see a consistent application as part of a global framework particularly given the low transparency of how the ratings are produced by the rating agencies. On the other hand, given the highly regulated nature of banks, we think the consideration of the regulatory environment / the interconnectivity / strategic importance to the government is an integral and essential part of the holistic credit risk assessment of the banks. • The proposal of excluding government support from bank ratings may not be appropriate in Asia, even if pure 'standalone' bank ratings from ECAI's were to become available. While the governments in USA/Europe are now reluctant to use taxpayers' money to support banks, in most parts of Asia the governments are expected to support banks during crisis (for example, in Japan, where government ownership of commercial banks is minimal, the government prefers preemptive capital support to banks over a

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			financial system disruption). So including government support in the PDs of Asian banks would be appropriate, unless legislation is enacted in a jurisdiction to exclude any capital support from the government to the banks.
2.	Main body; Section 1: Proposed revisions to the standardised approach for credit risk	**Section 1.1.1 Exposures to banks** (b) Standardised Credit Risk Assessment Approach (SCRA) *(Page 5-6)*	• By the same token, we propose that the IRB banks are allowed to make use of its internal ratings (if available) to derive a mapping to the SCRA grades for capital calculation. This will avoid the unnecessary operational overhead in, and not to mention the confusions resulted from, having to conduct assessment twice for every counterparty under two rating systems, i.e. the internal IRB and the Standardised SCRA. Only for the counterparties which cannot be rated (e.g. out of model scope) by the internal IRB models that SCRA grades are to be determined based on the outlined criteria. One of the criteria to assign a particular exposure to SCRA grades is the capacity of the counterparty to meet its financial commitments in the event of adverse changes in business or economic conditions, and one bank member would like to seek further clarification and guidance as to how best to assess the capacity in these adverse conditions. • For jurisdictions where external ratings are not accepted by the

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			regulators, the three tier grade framework proposed under SCRA should have some more risk drivers related to asset quality and operating performance, rather than just exceeding the published minimum regulatory requirements and buffers stipulated by its national supervisors. Could the committee please clarify the requirement on the frequency of update the financial ratios/buffers? For instance, would it be acceptable to collect annual updates rather than quarterly updates to ease the data collection burden of reporting institutions?
3.	Main body; Section 1: Proposed revisions to the standardised approach for credit risk	**Section 1.1.1 Exposures to banks** Risk weight floor *(Page 6)*	We consider it's a reasonable proposal to apply the risk weight floor of Sovereign risk weight under the SCRA, except for the counterparties that have been assessed using a regulatory-approved internal IRB model under which the macroeconomic environment and risks the counterparty's country of primary operations would have been assessed as part of the overall rating assignment (for example, applying Sovereign Ceiling) in the same way as the considerations cited for the external ratings.
4.	Main body; Section 1: Proposed revisions to the standardised approach for credit risk	**Section 1.1.1 Exposures to banks** Considerations about the proposal *(Page 6-7)*	While the proposal to enhance disclosure requirements about the banks' credit risk assessment methodologies is a good step, to assist counterparty credit analysis (of other banks), it would help if the public disclosures on loans/securities portfolios, funding/liquidity profiles are made more granular and standardized for banks across jurisdictions.
5.	Main body;	**Section 1.1.2 Exposures to**	• For ECAI rated exposures: similar to the comments above for bank

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	Section 1: Proposed revisions to the standardised approach for credit risk	**corporate** *(Page 7)*	exposures, we propose that for IRB banks the existing process of generating internal ratings be considered as a sufficient evidence of the due diligence required. Should the internal rating indicate a more conservative risk weight than that from the mapped external rating, the internal risk weight will be assigned so as to fulfill the requirement under the due diligence analysis. In addition, one possible downside of the "due diligence" process is that it could lead to different effective risk weights assigned to identical exposures across different institutions, thus reduce comparability and consistency. • Lower risk weight of 85% for exposures to SMEs : we support the proposal of assigning a lower risk weight for exposures to SMEs based on the same considerations as quoted in the proposal (i.e. highly collateralized with physical assets and lower asset value correlation) and to align the definition of SME with that in the IRB approach. We suggest that the committee may also review at the same time the calibration of the SME exposures (i.e. consolidated sales being less than €50 million threshold) given this definition was drawn up based on the market / data more than 10 years ago.
6.	Main body; Section 1: Proposed revisions to the	**Section 1.2 Specialised lending exposures to corporate** *(Page 8)*	Use of external ratings: we support in general the Committee's proposal to reintroduce the external ratings and in particular the use of *issue-specific* external ratings when assigning risk weights to the

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	standardised approach for credit risk		specialized lending exposures. However we have the following clarifications / comments : • Why the application of *issue-specific* external ratings only limited to project finance, object finance and commodities finance? Is it possible that IPRE exposures (e.g. REIT) may also have external ratings to be used for the same purpose? • It would be more appropriate to apply the same risk weight mapping by credit grade for the specialised lending exposures that is currently available under the IRB supervisory slotting approach, rather than the proposed risk weight mapping to general corporate exposures. The risk weight under the IRB Supervisory Slotting approach is believed to have been calibrated to the specific transactional characteristics of specialized lending exposures, rather than the risk of the counterparty only. This also sees the benefits of consistency with the IRB approach yet without additional complexity. • For further risk differentiation and consistency with the IRB approach, we propose that the Committee may consider to introduce a different risk weight mapping for specialised lending exposures with shorter maturity (e.g. less than 2.5 years) similar to those provisioned under the current IRB supervisory slotting approach.
7.	Main body; Section 1:	**Section 1.3 Subordinated debt, equity and other capital**	To avoid over simplicity and loss of risk sensitivity, we suggest

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	Proposed revisions to the standardised approach for credit risk	**instruments** *(Page 8-9)*	differentiating risk weighting of subordinated debt other than capital instrument from capital instruments. We support to apply issue-specific external rating-based risk weighting to sub-debts other than capital instruments unless empirical loss experience or quantitative impact analysis result indicate the loss severity of sub-debt other than capital instruments are similar to the loss severity of capital instruments.
8.	Main body; Section 1: Proposed revisions to the standardised approach for credit risk	**Section 1.4 Retail Portfolio** *(Page 9-10)*	• We agree with the committee that no risk driver exists that can adequately and consistently differentiate the retail portfolio. However, the 75% risk weight has been in place for a number of years and it is unclear if the committee has reviewed the calibration to ensure it remains appropriate. There is certainly a large difference between risk weights observed under IRB to the standardised risk weight which may mean revision of the 75% risk weight is appropriate. • Furthermore we would suggest that definitions used in that standardised approach and under IRB are fully aligned to remove unnecessary deviation and improve comparability and understanding.
9.	Main body; Section 1: Proposed revisions to the standardised approach for credit risk	**Section 1.5 Real estate exposure class** *(Page 11-12)*	• We agree in general with the Committee's proposal in the revised taxonomy of the real estate exposure class and the associated risk weight structure. We consider this will help simplify the asset classification process and at the same time enhance the risk differentiation among the real estate backed exposures.

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			• However, one member bank did make below recommendations as they believe can enhance the treatment of real estate exposures: - The large discrepancy between risk weights allocated to low LTV exposures and equivalent risk weights under the IRB approach, should be considered and the gap closed by significantly reducing the proposed standardised risk weights - Risk weights that are applied to exposures that are materially dependent on cash flows generated from the property, appear to be disproportionate to the underlying risk. It is unclear how risk weights of 70%-120% for exposures secured on property are appropriate, when compared to a risk weight of 75% to the same counterparty on an unsecured basis. As a general rule all exposures secured on completed properties should have a lower risk weight applied than that of an equivalent unsecured exposure. - On property under construction (paragraph 50), we have the following recommendations: o Property under construction is ‘unfinished property” and we suggest it to be separated from ‘finished property’ to avoid confusion; o The two criteria on property under construction would make Asian properties almost impossible to apply given they are often apartments or units of large development

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			projects; and they are often lack of sovereign guarantee on property completion. Many countries in Asia have well developed mortgage systems on under construction properties. The above criteria will remove the opportunity to consider high quality under construction properties as collateral, treating them as unsecured exposures. This would adversely impact a number of real estate markets. Please reconsider to remove both criteria and include say for example, the ranking of legal charge to replace the physical requirement which are both irrelevant to its risk sensitivity and could vary by jurisdiction. The specific government support is also rarely seen in other collateral requirement. • In the third paragraph *"Under this new taxonomy, exposures secured by either residential or commercial real estate would receive differing risk-weight treatments depending on whether repayment of the loan is materially dependent on the cash flows generated by the property. This is the main characteristic used to define specialised lending. Risk weights applied to exposures where there is material dependence would be relatively higher than risk weights applied when there is no material dependence."*, we would appreciate if an indicative threshold to determine whether repayment of the loan is

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			materially dependent on the cash flows generated by the property securing the loan can be given. Moreover, additional guidance on whether banks are expected to only check against the threshold at the initial loan drawdown date or have to regularly monitor if the threshold is breached thereafter may be provided. • For "Residential RE exposures" AND "Operational requirement not met": The summary chart on page 12 indicates that a uniform risk weight of 100% is to be applied, whilst Annex 1 paragraph [55] states "*Where the requirements in paragraph [50] are not met, the risk weight will be the higher of 100% or the risk weight of the counterparty, provided that paragraphs [56] and [61] are not applicable.*" Please clarify which is the intended proposal. • For Residential RE / Commercial RE exposures under General Treatment (i.e. repayment not materially dependent on cash flows generated by property) but operational requirement not met: our view is the risk weight treatment under this scenario should not be higher than that of unsecured portfolio. • One member bank commented that the valuation methodology suggested as the basis of the LTV calculation should be revisited. The use of origination valuation is not risk sensitive and, as a valuation taken at a single point in time, is subject to the market

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			conditions at that point. Utilizing this will incorporate the negative aspects of inconsistent cyclical effects into the approach, whilst the improved risk sensitivity of a mark-to-market valuation is unrealized. In our view a mark-to-market valuation would be the most suitable and readily available valuation. This is already provided for within the IRB rules for recognizing real estate as collateral, where residential property requires monitoring every three years.
10.	Main body; Section 1: Proposed revisions to the standardised approach for credit risk	**Section 1.5 Real estate exposure class** 1.5.3 Land acquisition, development and construction (ADC) exposures *(Page 14)*	150% RW is proposed to be applied to ADC exposures because of the uncertainty of repayment source from future sale of the property or from its uncertain cash flows. We believe this risk-weighting approach is overly simplistic and would result in a loss of risk sensitivity. In practice, credit decision of ADC loans usually are made in condition of comprehensive risk control measures including account control, conservative LTV criteria, the third party guarantee, and periodical drawdown arrangement by development stage after the periodical review of construction progress, etc. to mitigate potential loss arising from the future uncertain sale of the property or cash flows whose source of repayment is substantially uncertain.

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			To strike a balance between simplicity and risk sensitivity, we suggest the following for consideration: • Narrow down the definition by referring those loans extended to companies or SPVs which are single project company of which financings are provided for the related land acquisition, development and construction of any residential or commercial properties where the source of repayment at origination of the exposure is either the future uncertain sale of the property or cash flows whose source of repayment is substantially uncertain, i.e. loans are extended merely on a non-recourse project loan basis without any financial or guarantee support from other sources. • A two-scale risk weight to be introduced to capture risk variation in these real estate exposures. The supervisory slotting criteria for "income-producing real estate" and"high-volatility commercial real estate" (HVCRE) under IRB framework can be simplified to determine the risk-weighting under SA, and preferential risk weight should be applied for ADC with remaining maturity of less than 2.5 years accordingly.
11.	Main body; Section 1: Proposed revisions to the standardised approach for	<u>**Section 1.5 Real estate exposure class**</u> 1.5.3 Land acquisition, development and construction (ADC) exposures *(Page 14)*	In practice, it is hard to identify "loans to companies or individuals to finance acquisition of finished property where the repayment of the loan depends on future uncertain sale of the property". Credit decision is usually based on the overall assessment on all repayment sources and

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	credit risk Annex 1 Proposals on risk weighting for exposure classes and credit risk mitigation (A. Individual exposures)	 **<u>Annex 1 Section 9. Real estate exposure class</u>** 9.3 Land acquisition, development and construction exposures *Paragraph [61]* *(Page 37)*	ability of the obligors, including property as collateral as the second source of repayment. For the sake of conservativeness and simplicity, we suggest excluding these loans from "ADC exposures". Instead, "loans to companies or individuals to finance the acquisition of finished property" can be classified under Residential RE / Commercial RE exposures accordingly and treated with the corresponding proposed risk-weighting.
12.	Main body; Section 1: Proposed revisions to the standardised approach for credit risk Annex 1 Proposals on risk weighting for exposure classes and credit risk mitigation (A. Individual exposures)	**<u>Section 1.6 Risk weight add-on for exposures with currency mismatch</u>** *(Page 14-15)* **<u>Annex 1 Section 10. Add-on risk weight to certain exposures with currency mismatch</u>** *Paragraph [62] and [63]* *(Page 38)*	• We do not see the need of including the Corporate portfolio into the scope of currency mismatch risk weight add-on as in the revised proposal, with the following considerations : ➢ the Committee's assumption in the initial consultative document which proposed to apply the add-on to only the retail and residential real estate exposures is still valid, i.e. that the individuals or micro-firms generally do not manage or hedge their foreign exchange risk; ➢ for the rated corporates, their credit ratings will typically have taken into considerations their foreign exchange risks of income / expenses, currency convertibility and transferability risks, and the existence / effectiveness of any mitigation against such risks; ➢ corporates will usually have more than one single source of income thus even there is a provision to exempt from the risk weight add-on as a result of natural or financial hedge, it will be

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			operationally cumbersome if not infeasible to evidence the existence of such "natural hedge" • In addition, the proposed flat risk weight add-on of 50% appears to be highly punitive and overly simplistic. This add-on overestimates the potential loss from foreign exchange risk under some circumstances, below are some examples for consideration to be exempted for this add-on: ➢ Under linked exchange rate system, foreign exchange risk is remote. We suggest to exempt risk weight add-on from exposures with currency mismatch under linked exchange rate system. ➢ In retail credit, banks apply the haircut of currency mismatch when assessing debt service capacity of borrowers where the lending currency differs from the currency of the borrowers' main source of income. Potential loss from foreign exchange risk is effectively controlled with this measure.
13.	Main body; Section 1: Proposed revisions to the standardised approach for credit risk	**<u>Section 1.7 Off-balance sheet exposures</u>** 1.7.1 Unconditionally cancellable commitments (UCC) *(Page 15)*	• We agree to narrow the scope of this category to commitments that are unconditionally cancellable in practice. i.e. Annex 1 paragraph [69] *retail commitments that are unconditionally cancellable at any time by the bank without prior notice, or that effectively provide for automatic cancellation due to deterioration in a borrower's*

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			creditworthiness. However, the revised proposal seems to penalize this narrowed scope retail UCC to apply higher CCF. • The revised proposal appears to be going for another extreme for non-retail commitments, i.e. those unconditionally cancellable corporate exposures which are currently subject to 0% CCF will now be subject to a 50%-75% CCF. There seemed not to have any supporting / evidence to justify such change. We strongly oppose such approach, as in our experience the UCCs are managed proactively and there is certainly difference between the UCCs and the non-UCCs evidenced by the historical data. The difference is reflected in the facility cost and pricing, which in turn reflects the anticipation as well as historical experience of the lower risks / losses from such UCC facilities, and this supports that there should be a differentiated / lower CCF for UCC than the non-UCC facilities. • The terms revocable/irrevocable appears in the BCBS Consultation of the Revised Pillar 3 disclosures requirements but not in the Consultation of the revised Standardised approach. For avoidance of doubt, would the committee please confirm whether "revocable" is equivalent to "unconditionally cancellable"? • It would be extremely beneficial for the committee to clarify if there

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			are any conditions where recognition of an exposure can be postponed. There are a number of circumstances under which an institution is legally committed but where conditions exist that would preclude actual drawings. These conditions can vary, but can include mandatory regulatory or competition approval, subsequent credit reviews by the lender and shareholder approval in the case of mergers and acquisitions. Currently, the treatment of these exclusions is not consistent across jurisdictions and institutions. To ensure comparability of exposures and RWAs, clarification in this area is required. We would recommend that where a contractual agreement is in place, but this is contingent on either a subsequent decision of the institution to provide funds or the mandatory approval of an independent regulatory or government body, recognition of an exposure is postponed until the contingent factors are met. This would exclude contingent factors that an institution would reasonably expect to be completed, as well as any factors in the control of the customer or third party which is not an independent regulatory or government body. • While these concepts and issues are not new under the proposals, this is an opportune moment to refine the text to avoid jurisdictional variations.
14.	Main body; Section 1:	**<u>Section 1.9 Exposures to multilateral development banks</u>**	• We see no intrinsic issues with the revised proposal in the MDB risk

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	Proposed revisions to the standardised approach for credit risk	**<u>(MDBs)</u>** *(Page 17-18)*	weight treatment, both for those eligible for 0% RW MDBs, and for other MDBs which will be risk weighted by their external ratings. • We would like to clarify whether the Committee intends to maintain and publish the eligible MDB for 0% RW on an ongoing basis according to its renewed criteria of "AAA rating at entry, and not-worse-than AA(-) once on the list".
15.	Annex 1 Proposals on risk weighting for exposure classes and credit risk mitigation (A. Individual exposures)	**<u>Annex 1 Section 4. Exposures to banks</u>** *Paragraph [13]* *(Page 27)* **<u>Annex 1 Section 5. Exposures to securities firms and other financial institutions</u>** *Paragraph [30]* *(Page 30)*	To avoid ambiguity, would the committee please specify in the rule text what "prudential standards" refer to?
16.	Annex 1 Proposals on risk weighting for exposure classes and credit risk mitigation (A. Individual exposures)	**<u>Annex 1 Section 4. Exposures to banks</u>** (b) Standardised Credit Risk Assessment Approach (SCRA) *Paragraph [21], [24] & [27]* *(Page 29)*	With reference to section 1.1.1. in page 5 of this consultation document, we notice that "*published minimum regulatory requirements (eg leverage, liquidity and risk-based capital ratios) and buffers (eg GSIB surcharge, capital conservation and countercyclical capital buffers)*" are mentioned. We expect the same definition "published minimum regulatory requirements and buffers" applied here.
17.	Annex 1 Proposals on risk	**<u>Annex 1 Section 6. Exposures to corporate</u>**	In reality, a bank can grant loans to corporate borrower for various loan usages, in which some lending are for ADC (land acquisition,

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	weighting for exposure classes and credit risk mitigation (A. Individual exposures)	*(Page 30-31)*	development and construction) financing, while others are not. For the asset categorization purpose, our understanding is that the ADC exposures should be identified at transaction level rather than at the customer level. For example, if a bank grants two facilities to one company, in which loan A is exclusively for ADC financing, while loan B is exclusively for its retail or transport business. In this case, loan B should NOT be treated as ADC exposures. Please confirm the interpretation.
18.	Annex 1 Proposals on risk weighting for exposure classes and credit risk mitigation (A. Individual exposures)	**Annex 1 Section 6. Exposures to corporate** *6.2 Specialised lending* *Paragraph [41]* *(Page 32)*	Could the committee define "declining long term debt" - the criteria for a debt to be regarded as declining long term debt?
19.	Annex 1 Proposals on risk weighting for exposure classes and credit risk mitigation (A. Individual exposures)	**Annex 1 Section 9. Real estate exposure class** 9.1 Residential real estate exposures *Table 9* *(Page 36)*	Consideration needs to be given for the large discrepancy between risk weights allocated to low LTV exposures and equivalent risk weights under the IRB approach. A 25% risk weight for an exposure that has an LTV of 40%, where PD risk is low and LGD risk negligible, is not commensurate with the underlying risk.
20.	Annex 1 Proposals on risk weighting for exposure classes	**Annex 1 Section 9. Real estate exposure class** 9.1 Residential real estate exposures	For those non-defaulted real estate exposures meeting the requirements in paragraphs 56, 60 and 61, the document proposes risk weight at 150% which is the same as defaulted exposures. We believe this

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	and credit risk mitigation (A. Individual exposures)	*Paragraph [56]* *(Page 36)* 9.2 Commercial real estate exposures *Paragraph [60]* *(Page 37)* 9.3 Land acquisition, development and construction exposures *Paragraph [61]* *(Page 37)*	risk-weighting approach is overly simplistic and would result in a loss of risk sensitivity.