KFB comments on Basel Committee’s Second Consultative document on Revisions to the Standardised Approach for Credit Risk

The Korea Federation of Banks (KFB) is a bankers’ association that represents and promotes the interests of the Korean banking industry as a whole. Our membership comprises banks both domestic and international, operating in Korea.

The Korea Federation of Banks has collected, and hereby submits Korean banks’ views on Basel Committee’s Second Consultative document on Revisions to the Standardised Approach for Credit Risk. This document points out some issues of the consultative document and suggests recommendations reflecting the current situation in Korea after consulting with Korean banks.

1. Bank exposures

☐ Essential to clarify the classification criteria applied to standardised credit ratings and to disclose related data

☐ Details proposed in the second consultative document

- Unrated bank exposures in jurisdictions that allow the use of external credit rating agency ratings (hereinafter referred to as "external ratings"), or bank exposures in jurisdictions that do not allow the use of external ratings would be classified into one of three standardised credit risk assessment buckets (i.e. Grades A, B and C) with different risk weights applied (50% for Grade A, 100% for Grade B and 150% for Grade C) depending on a counterparty’s repayment capacity, published minimum regulatory requirements, and buffers established by its national supervisor as implemented in the jurisdiction where the borrowing bank is incorporated.
Issues

- The criteria applied to repayment capacity is ambiguous to judge whether a counterparty has adequate capacity to meet its financial commitments, resulting in the use of subjective criteria by respective bank and thus potentially undermining the reliability of standardised credit risk assessment results.

- At a working level, it is a challenge for an individual bank to check the compliance status of a counterparty bank and to monitor minimum regulatory requirements published by respective country, all in a periodic manner.

Our comments

- Data for regular disclosure or disclosure, such as ROA, ROE and net interest margin, could easily be accessed to calculate quantitative indicators. There is a need to use such indicators as criteria to judge a counterparty’s repayment capacity.

- If published minimum regulatory requirements and buffers established by respective national supervisor as implemented in the jurisdiction where a borrowing bank is incorporated are to be maintained as part of the criteria used for the standardised credit risk assessment approach, then there exists a need for the Basel Committee to collect and disclose relevant data on a regular basis (including minimum regulatory requirements by country, the level of required buffers established by country, regulatory requirements by bank, and the status of required buffers established by bank).
Essential to clarify the scope of "public banks owned by their governments" that are allowed to use external ratings graded based on the potential government support

- Details proposed in the second consultative document
  - For bank exposures in jurisdictions that allow the use of external ratings, use the external ratings exclusive of potential government support (External ratings of public banks owned by their governments are excluded from this requirement)

- Issue
  - The scope of "public banks owned by their governments" is vague.

- Our comment
  - It is necessary to state that, "In the scope of public banks owned by their governments, public banks whose losses are covered by the government or whose shares are owned by the government above a certain level shall be included."

2. Equity Exposures

- Necessary to introduce a lower risk weight for exposures to equities issued by public institutions and companies with high ratings

- Details proposed in the second consultative document
  - Equity holdings that are not deducted will receive a 250% risk weight while subordinate debt and capital instruments other than equities will receive a risk weight of 150%.

- Issue
  - The simple risk weight treatment makes it difficult to adequately reflect the actual risk hierarchy involving an equity issuer's credit rating and equity holdings.
- Our Comments

- For the exposure to equities issued by a public institution whose losses are covered by the government or whose shares are owned by the government at a significant level, it is essential to risk-weighting the exposure based on the sovereign rating where the public institution is established as implemented under the current framework.

- For the exposure to equities issued by a company with high external rating and low debt ratio, it is necessary to apply a low risk weight if certain conditions, such as its listing status, are met.

3. Exposures secured by real estate collateral*

* Collateral classified into real estate in general and income-producing real estate (IPRE)

☐ Calling for lowering the risk weight applied to the exposure secured by IPRE and for establishing pertinent guidelines

- Details proposed in the second consultative document

- For real estate exposures satisfying given requirements*, risk weights would be assigned based on the exposure’s LTV** ratio.

* Requirements include (1) the property securing the exposure must be fully completed; (2) any claim on the property taken must be legally enforceable; (3) higher ranking liens over the property; (4) ability of the borrower to repay; (5) prudent value of property; and (6) all the information required at loan origination should be property documented.

** Loan-To-Value ratio (loan divided by the value of the collateral property)

- Higher risk weights are assigned to exposures secured by IPRE than those by real estate in general
## Risk weight table for residential real estate exposures

<table>
<thead>
<tr>
<th>LTV</th>
<th>LTV ≤ 40%</th>
<th>40%&lt; LTV ≤ 60%</th>
<th>60%&lt; LTV ≤ 80%</th>
<th>80%&lt; LTV ≤ 90%</th>
<th>90%&lt; LTV ≤ 100%</th>
<th>LTV &gt; 100%</th>
</tr>
</thead>
<tbody>
<tr>
<td>risk weight</td>
<td>General</td>
<td>25%</td>
<td>30%</td>
<td>35%</td>
<td>45%</td>
<td>55%</td>
</tr>
<tr>
<td>requirements met</td>
<td>IPRE</td>
<td>70%</td>
<td>70%</td>
<td>90%</td>
<td>120%</td>
<td>120%</td>
</tr>
<tr>
<td>risk weight</td>
<td>General</td>
<td>100%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>requirements not met</td>
<td>IPRE</td>
<td></td>
<td>150%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

## Risk weight table for commercial real estate exposures

<table>
<thead>
<tr>
<th>LTV</th>
<th>LTV ≤ 60%</th>
<th>60% &lt; LTV ≤ 80%</th>
<th>80% &lt; LTV</th>
</tr>
</thead>
<tbody>
<tr>
<td>risk weight</td>
<td>General</td>
<td>RW of Counterparty</td>
<td></td>
</tr>
<tr>
<td>requirements met</td>
<td>IPRE</td>
<td>80%</td>
<td>100%</td>
</tr>
<tr>
<td>requirements not met</td>
<td>General</td>
<td>Max(100%, RW of Counterparty)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>IPRE</td>
<td></td>
<td>150%</td>
</tr>
</tbody>
</table>

### Issues

- Excessively high risk weights are assigned to the exposures secured by IPRE compared to the general treatment. When compared to unsecured retail exposures, the risk weight assignment lacks consistency.

  - Risk weights between 25% and 55% are assigned to the residential real estate exposures in general (whose LTV is less than 100%), but higher risk weights between 70% and 120% are assigned to residential real estate exposures when the real estate collateral is IPRE.
  - Risk weights(90%-120%) assigned to residential IPRE exposures with LTV ratio exceeding 60% are higher than the weights(75%) assigned to unsecured retail exposures.
The definition of income-producing real estate (IPRE) exposures* is ambiguous.

* When a borrower is materially dependent on the cashflows generated by the property securing the loan for repayment, its exposure to such property is categorized as IPRE exposure.

- Specific criteria is inadequate for determining a borrower's material dependence on the cashflows generated by the property securing the loan for repayment.

○ Our comments

- It is essential to lower risk weights assigned to IPRE exposures while ensuring consistency in such assignment.
  
  - Banks already make conservative valuation of income generated by assets provided as collateral and of a borrower's repayment capacity when underwriting loans secured by IPRE.
  
  - Consistent assignment of risk weights is essential based on holistic review of risk weights assigned to real estate exposures in general and unsecured retail exposures.

- Specific criteria is required for the distinction of income-producing real estate (IPRE) exposures.

  • (Example) When it is impossible to make repayment only with cashflows generated by assets provided as collateral, repayment is considered to be not materially dependent on such cashflows. Therefore, the exposure is ruled out of the IPRE exposures.
4. Specialised lending exposures

* Project Finance (PF), Object Finance (OF), and Commodities Finance (CF)

- **Essential to assign same risk weights assigned to corporate exposures while assigning single risk weights to PF**

- **Details proposed in the second consultative document**

<table>
<thead>
<tr>
<th>Risk weight</th>
<th>Specialised lending exposures of banks incorporated in jurisdictions that allow the use of issue-specific external ratings(^1)</th>
<th>Specialised lending exposures of banks incorporated in jurisdictions where issue-specific external ratings are either not available or not allowed (hereinafter referred to as &quot;unrated specialised lending exposures&quot;)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Same risk weights assigned to corporate exposures of banks incorporated in jurisdictions that allow the use of external ratings (20%~150%)</td>
<td>OF(^2)</td>
</tr>
<tr>
<td></td>
<td>120%</td>
<td>150%</td>
</tr>
</tbody>
</table>

\(^1\) Credit ratings assigned to bonds issued by companies based on their repayment capacities

\(^2\) Object Finance refers to the method of funding the acquisition of tangible assets such as ships and aircraft

\(^3\) Commodities finance refers to structured short-term lending to finance reserves, inventories, or receivables of exchange-traded commodities, where the loan will be repaid from the proceeds of the sale of the commodity

\(^4\) Project finance refers to the method of funding for large and expensive installations, such as power plants and transportation infrastructure.

\(^5\) Operational phase refers to the method in which the project has (i) a positive net cashflow that is sufficient to cover any remaining contractual obligation, and (ii) declining long term debt.

- **Issues**

- Higher risk weights are assigned to unrated specialised lending exposures than those applied to unrated corporate exposures.

  * Corporate exposures either without external credit ratings or without the possibility of using external ratings, if any, are assigned with risk weights of 75% or 100% depending on the corporate status of investment grade (For unrated exposures to corporate SMEs, an 85% risk weight will be applied).

- For large-scale project finance usually involving overseas construction and plants, a loan is parcelled out depending on a project's progress rate. Therefore, the exposure is highly unlikely to increase when a project stops or when a borrowing entity’s credit rating is downgraded. Furthermore, project assets are provided as collateral while future cashflows from a project serve as the source for loan repayment. Thus, PF risks are deemed to be not greater than corporate exposures.

  * For the past 10 years, the average annual default rate of specialised lending is approximately 0.09% according to the Export-Import Bank of Korea.
- Also in the case of object finance (OF), real assets including ships under construction are acquired as collateral while securing project cashflows (i.e., freight charges) to be used for repayment. As such, there are various measures in place to ensure repayment. Therefore, the involved risks are deemed to be not greater than corporate exposures.

- For unrated PF exposures, different risk weights are assigned to pre-operational phase and operational phase even though it would be hard to assume that risks at the former stage are greater than those at the latter stage.

- As for PF, completion guarantee is provided by multiple project owners during the pre-operational phase. Furthermore, a reserve account* is set up to secure the source for repayment.

* A reserve account is where a portion of loan principal to be repaid in the future is set aside separately without being released.

○ Our comments

- For unrated specialised lending exposures, it is essential to assign same risk weights assigned to unrated corporate exposures.

- For unrated PF exposures, there is no need to assign different risk weights by project phase.
5. Certain exposures with currency mismatch

- Withdrawal of add-on risk weight to certain exposures with currency mismatch
  - Details proposed in the second consultative document
    - For retail and residential real estate exposures where the lending currency differs from the currency of the borrower’s main source of income, an add-on of 50%p to the risk weight will be applied (subject to a maximum risk weight of 150% after the add-up).
  - Issues
    - Unless a borrower is legally obliged to submit the currency of its main source of income to a bank on a regular basis, it is practically difficult to collect accurate information about the currency of the borrower’s main source of income.
    - There exists a possibility of a bank transferring the capital injection burden driven by such add-on risk weight to its customers in the form of higher lending rates and less lending among others.
  - Our comment
    - Withdrawal of add-on risk weight to certain exposures with currency mismatch

6. Off-balance sheet exposures

- Essential to apply different Credit Conversion Factor (CCF)* to general commitments by term and by feature
  
* For off-balance sheet items (payment guarantee, credit line, etc.) that are not stated in the main body of financial statements, their exposures are their nominal principal multiplied by credit conversion factor.
Details proposed in the second consultative document

<table>
<thead>
<tr>
<th>Types</th>
<th>Current CCF</th>
<th>Proposal for revised SA</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>SA</td>
<td>IRB</td>
</tr>
<tr>
<td>Commitments* that are unconditionally cancellable by a bank at any time without prior notice, or that effectively provide automatic cancellation due to deterioration in borrower’s creditworthiness</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>commitments, except retail unconditionally cancellable</td>
<td>-</td>
<td>75%</td>
</tr>
<tr>
<td></td>
<td>20%</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>50%</td>
<td>-</td>
</tr>
<tr>
<td>NIF and RUF</td>
<td>50%</td>
<td>75%</td>
</tr>
<tr>
<td>certain transaction-related contingent items</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>short-term self-liquidating trade letters of credit arising from the movement of goods</td>
<td>20%</td>
<td>20%</td>
</tr>
</tbody>
</table>

* The second consultative document proposed the scope of unconditionally cancellable commitments (UCC), to which a reduced CCF is applied, to be restricted to retail commitments.

Issues

- If CCF applied to corporate UCC is as conservative as that applied to general commitments, then regulatory capital requirements for items with differing risks would be identical. This is not in alignment with the purpose of revising the standardised approach for credit risk.

- Where an increased CCF is applied to general commitments across the board regardless of respective commitment term, it would be inevitable for a bank to reduce loan limits of certain accounts including SMEs while implementing tighter loan underwriting. The function of the banking sector backing up the real economy is expected to be weakened.
○ Our comments

- It is essential to apply lower CCF to corporate UCC than that applied to general commitments.

- It is necessary to differentiate the CCF for general commitments by term and by feature.
  
  • In light of the impact on the real economy, it is essential to differentiate CCF by term even if CCF is increased (i.e., 30% for the short term and 75% for the long term).

  • Additional withdrawal amounts may differ by exposure feature until the occurrence of default. Therefore, a national discretion is essential, based on the supervisory authorities' review of historic data by exposure type, for differentiating CCF for exposure types with significantly small amount withdrawn for a certain period before the default.
- Our comments

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- It is necessary to differentiate the CCF for general commitments by term and by feature.
  
  - In light of the impact on the real economy, it is essential to differentiate CCF by term even if CCF is increased (ie 30% for the short term and 75% for the long term).

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Thank you for providing the opportunity to industry stakeholders to comment on BCBS's "Revisions to the Standardised Approach for credit risk". The KFB and its members shall continue to closely follow future developments regarding this work stream.

Yours sincerely,

Kun Ki Hong
Vice chairman
Korea Federation of Banks