BANK FOR INTERNATIONAL SETTLEMENTS

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Overview of the revised credit risk framework – Executive Summary

The Basel Committee on Banking Supervision (BCBS) has revised the credit risk framework as part of the Basel III reform package. The revisions seek to restore the credibility in the calculation of risk-weighted assets (RWAs) and improve the comparability of banks' capital ratios.

As under Basel II, the revised credit risk framework provides two main approaches for calculating credit RWAs:

Standardised approach (SA) – Under the SA, banks use a prescribed risk weight schedule for calculating RWAs. Similarly to Basel II, the risk weights depend on asset class and are generally linked to external ratings, but enhancements have been introduced.

Internal ratings-based (IRB) approach – Under the IRB approach, banks can use their internal rating systems for credit risk, subject to the explicit approval of their respective supervisors. Similarly to Basel II, banks can use either the advanced IRB approach (ie use their internal estimates of risk parameters such as probability of default (PD), loss-given-default (LGD) and exposure-at-default (EAD)) or the foundation IRB approach (ie use only their internal estimates of PD). However, enhancements to and constraints on the application of IRB approaches for certain asset classes have been introduced under Basel III.

Standardised approach (SA)

The following are the main changes to the credit risk SA:

Motivation	Main changes
Reduce mechanistic reliance on external credit ratings	• Requirement for banks using credit ratings to conduct sufficient due diligence • Adoption of a sufficiently granular non-ratings-based approach for jurisdictions that cannot or do not wish to rely on external credit ratings

Improve granularity and risk sensitivity	• Adoption of a more granular risk weighting approach, particularly for the following credit risk exposures in which a flat risk weight currently applies:
	    o residential real estate
	    o commercial real estate
	    o subordinated debt and equity
	    o unrated exposure to banks
	• Adoption of a more granular risk weighting approach to rated exposures to corporates, and a more granular treatment of retail exposures
	• Recalibration of risk weights for rated exposures to banks and of credit conversion factors for off-balance sheet items

Internal ratings-based (IRB) approach

The following are the main changes to the credit risk IRB approach:

Motivation	Main changes
Address the lack of robustness in modelling certain asset classes and enhance comparability in banks' IRB capital requirements	• Removal of the option to use the advanced IRB approach for certain asset classes • Adoption of "input" floors (ie for internal estimates of PD and LGD) to ensure a minimum level of conservatism in model parameters for asset classes where the advanced IRB approach remains available • Provide greater specification of parameter estimation practices

Implementation timeline

Both the revised SA and IRB approach will be implemented on 1 January 2022.

This Executive Summary and related tutorials are also available in FSI Connect, the online learning tool of the Bank for International Settlements.