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Strong banks – strong Australia

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Secretariat
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
SWITZERLAND

Dear Secretariat

BCBS: Second consultative document: Standards: Revisions to the Standardised Approach for credit risk

The Australian Bankers' Association (**ABA**) welcomes the opportunity to provide feedback on the Basel Committee on Banking Supervision (**BCBS**) Second consultative document: *Revisions to the Standardised Approach for credit risk* (**consultative document**).

With the active participation of its members, the ABA provides analysis, advice and advocacy for the banking industry and contributes to the development of public policy on banking and other financial services. The ABA works with government, regulators and other stakeholders to improve public awareness and understanding of the industry's contribution to the economy and to ensure Australia's banking customers continue to benefit from a stable, competitive and accessible banking industry.

The ABA welcomes the revisions to the original proposals and acknowledges that the Committee has accommodated much of the industry's feedback. Allowing the use of credit ratings, where permitted by national authorities, will reduce the operational burden of the approach and align it more appropriately to the objectives of the Committee.

The ABA continues to be broadly supportive of the Committee's objective to review the Standardised Approach to credit risk and believes there are opportunities to further improve risk sensitivity and better align capital with risk without adding undue complexity.

The ABA also notes that this review is part of a larger consideration of risk-weighted assets by the Committee, which may include the introduction of a capital floor. The ABA remains concerned about the potential of a capital floor, coupled with the proposals in the consultative document and other initiatives of the Committee, to increase capitalisation of banks using the internal ratings-based (**IRB**) approach. The consideration of floors in any new framework should be the last step and should only, if required, be directed at outlier institutions whose models are not appropriately calibrated to their risks. In this regard, the ABA would endorse the Committee's intent that the proposed revisions to the standardised approach are not intended to raise capital levels through the system.

The ABA takes this opportunity to highlight areas which could benefit from further review to ensure greater alignment to BCBS objectives. The ABA will also provide our views on the proposed risk-weight calibration and granularity for certain exposure classes, noting that it is difficult to comment fully on the impact of the proposals given the other open elements of the BCBS reform agenda.

Residential and commercial real estate exposures

Definition of 'materially dependent'

For exposures secured by residential or commercial real estate, the consultative document draws a distinction between exposures where the repayment is materially dependant on cash-flows from property and those which are not dependent. The ABA would welcome BCBS guidance on the definition of 'materially dependent' to ensure exposures are consistently and appropriately classified across banks and jurisdictions.

This final definition will be critical as it will determine the extent to which the materially higher risk-weights in Table 10 (Pg. 36) will apply to retail residential mortgage exposures. We would note that our loan loss data demonstrates that Australian residential real estate exposures for investment purposes do not typically exhibit materially different risk to the types of exposures that we assume are intended to clearly caught by the lower risk-weights outlined in Table 9 (Pg. 36).

The ABA notes that the current QIS defines materially dependent exposures as those where greater than 50 per cent of the assessed income is from cash flow generated from property. The ABA supports the Committee's approach in seeking a definition that is both non-complex and straightforward to calculate.

However, based on that guidance, the ABA is concerned that there is potential for the higher risk-weights in Table 10 to be applied to residential real estate exposures which have not exhibited any materially different loss experiences from the high quality exposures captured by Table 9.

The ABA requests that further sensitivity analysis be undertaken before any final determination is made that 'materially dependent' is to be defined based on the 50 per cent threshold. This is to ensure that exposures that do not exhibit materially higher risk are not subject to the materially higher risk-weights of Table 10.

The ABA suggests that the Committee provides guidance on the detailed definitional matters, for example, the use of gross income or income net of risk adjustments.

The ABA considers that the definition should also include guidance as to the extent to which retail residential mortgage lending, which exhibits very low loss rates, is not intended to be captured. Beyond this, the Committee should also clarify that national supervisors are responsible for defining any further application of 'materially dependent' to reflect the characteristics of their local market.

Risk calibration

We have noted above that the logic behind the material increase in the risk-weights in Table 10, relative to Table 9, depends critically on the final definition of 'materially dependent'.

There are also concerns with the calibration of risk-weights in Tables 9 and 10.

The calibration of risk-weights in Table 9, commences at a 25 per cent risk-weight for exposures where the LTV is less than 40 per cent. ABA members recognise the Committee's desire to limit the potential leverage of real estate exposure but considers that this lowest risk-weight is much higher than would be justified by the loss experience of a loan with such a conservative LTV ratio. The desire for conservatism may over-ride this particular concern but this risk-weight also represents an anchor point from which the calibration of risk-weights for other LTV buckets occurs resulting in all risk-weights being overly conservative.

Further, the ABA considers that a secured retail exposure should, in most instances, be awarded a lower risk-weight than one that is unsecured. The Committee's proposal would see certain unsecured retail exposures risk-weighted at 75 per cent, while if that same retail exposure is secured against, and materially dependent upon the cash flows generated from property, it will receive a risk-weighting anywhere from 70 to 120 per cent. This outcome does not seem aligned with the relative underlying risk of the exposures.

Regarding those residential mortgage exposures that have lenders mortgage insurance (**LMI**) with an acceptable insurer. Provided the LMI covers exposures over LTV > 80 per cent (i.e. where the losses are transferred to the insurer), the ABA recommends that these exposures be capped at a risk-weight of 35 per cent, consistent with the risk-weight applied to an 80 per cent LTV exposure in Table 9.

The ABA acknowledges the Committee's timetable for finalisation of this revision to the Standardised Approach for credit risk. However, the ABA requests an additional period of consultation be undertaken once the QIS and additional sensitivity analysis around the materially dependent definition has been undertaken, with the consultation limited to the calibration between Tables 9 and 10.

Granularity

For residential real estate exposures the ABA considers that enhancements to risk sensitivity could be achieved by aligning the LTV buckets in Table 10 with the more granular buckets proposed in Table 9.

Even in Table 9, the proposed increase in risk-weights between LTV buckets in some cases is significant which may lead to unintended behaviours and outcomes disproportionate with the actual change in risk profile. For example, a residential mortgage borrower who is not dependent on cash flows generated from property would be subject to a risk-weight of 35 per cent for a LTV up to and including 80 per cent, however any increment above this results in a 45 per cent risk-weight applying to the entire exposure. This borrower may then be subject to a materially higher cost of finance for only a small increase in risk.

The ABA recommends consideration be made to including more LTV buckets in Tables 9 and 10 or allow for a blending of risk-weight calculation across the LTV buckets, such that the risk-weight changes continuously with increases or decreases in LTV.

Origination LTV

Currently in Australia, APRA's standardised approach allows the value in the LTV calculation to be revised upward where a formal valuation is sought:

> *"For this purpose, the valuation may be based on the valuation at origination or, where relevant, on a subsequent formal revaluation by an independent accredited valuer.[1]"*

The ABA considers that this approach should be maintained and that local supervisors be given discretion in this regard.

Paragraph 52 (and footnote 43) in the consultative document states that LTV is to be based on the valuation at origination unless national supervisors require banks to revise the value downward. The ABA would caution that there could be adverse consequences associated with allowing supervisors to revise values lower in order to force higher capital requirements. The use of such a blunt mechanism could have a negative systemic impact on a banking system that may already be operating in volatile market conditions.

Corporate exposures

The ABA suggests that additional risk sensitivity could be achieved for rated and unrated corporate exposures. Our principal concerns are:

- The proposed 100 per cent risk-weight applying to all rated corporate exposures rated BBB+ to BB- covers a material spread of external ratings and risks and does not currently provide the risk sensitivity that the Committee is seeking.

  For example, the 100 per cent risk-weight proposed for corporate exposure that is externally rated BBB+ is double the 50 per cent risk-weight applied to corporate exposure that is externally rated A- which is unlikely to be double the risk.

[1] Paragraph 5, Attachment D, APS 112

- In jurisdictions that permit the use of external ratings, some investment grade corporates (e.g. BBB) and all unrated entities carry an overly conservative risk-weight (100 per cent). This is particularly so when compared with the 75 per cent that 'investment grade' corporates can attract in jurisdictions that do not permit the use of external ratings. The issue of the conservative risk-weight applied to unrated entities is of particular concern in jurisdictions, such as Australia, where a majority of corporates are not rated.

The ABA submits that the Committee should allow all banks to identify and risk-weight at 75 per cent 'investment grade' unrated corporates using the definition in Annex 1 paragraph 173 (subject to the removal of the requirement that they have securities outstanding on a recognised securities exchange). This will provide capacity for low risk unrated corporate exposure to be subject to a lower risk-weight.

The ABA would then suggest that the risk-weight of corporate exposure that is externally rated BBB+ to BBB- be aligned to that of unrated investment grade.

This would amend Table 8 as below (changes underlined):

External Rating of counterparty	AAA to A-	A+ to A-	BBB+ to BBB-	BB+ to BB-	Below BB-	<u>Unrated Investment Grade (1)</u>	<u>Unrated - Other</u>
"Base" Risk-weight	25%	50%	75% ~~100%~~	100%	150%	75%	100%

(1) As defined within Annex 1 paragraph 173

Off-balance sheet exposures

The ABA seeks guidance on the definition of committed exposure, we seek to understand if, for example, a documented facility which specifically defines that facility as being uncommitted and cancellable, is actually a commitment for the purpose of risk-weighting. This is an important distinction when considering the comparability globally.

The consultative document proposes that the unconditionally cancellable commitments (**UCC**) scope be narrowed to retail commitments (e.g. credit cards) together with a reduced Credit Conversion Factor (**CCF**) of 10 to 20 per cent. All other UCCs would carry a CCF of 50-75 per cent, this is a significant step up on the prior proposed approach. The ABA considers the proposed treatment punitive, and not representative of the actual risk of these retail UCCs. The impact of the proposals as they stand are particularly acute for smaller Australian banks on the standardised approach.

The ABA is in agreement with the IBFed view that the Committee's requirement that a CCF must be greater than 0 per cent regardless of the exposure type is overly conservative, and is not consistent with the IRB approach. The ABA believes this does not achieve the goal of correctly quantifying the underlying risk associated with the lending product.

Where legal or contractual considerations provide evidence of non-retail contractual arrangements or product types that are binding and effectively operationalised, the ABA requests that the Committee considers lowering the CCF for both retail and non-retail products. The ABA believes the QIS will indicate an appropriate level of CCF calibration for these product types.

Bank exposures

The ABA is concerned with the lack of sufficient differentiation in risk-weights under the External Credit Risk Assessment Approach (**ECRA**) for banks. Under the proposals, exposure to banks that are externally rated A+ to A- are to be risk-weighted at 50 per cent which is the same as BBB+ to BBB-. The Committee would achieve greater risk sensitivity through a median risk-weight of 35 per cent to reflect the lower risk of A+ to A- exposures.

Bank ratings

The ABA notes that under the Committee's proposals, external ratings of banks must exclude assumptions of government support to be usable. The major rating agencies currently factor in such assumptions for issuer ratings. However the impact of this inclusion is not always clearly identified and hence the capacity for banks to manually strip out such assumptions is at best operationally complex and potentially not possible. The ABA notes that removing government support is a policy objective of the Committee and work is underway to achieve that outcome. Adding another layer of complexity to the standardised approach to deal with an issue that the ABA expects will be resolved in the near future would seem to work against the Committee's over-arching objective to make the framework simpler.

The ABA therefore requests that the Committee permits the use of bank ratings as they are currently published by the major rating agencies. The Committee would of course retain the option of revisiting this proposed simplification if the impact of government support is not resolved in the near future.

Additional feedback

There are some minor items where further guidance would be of assistance, particularly around several concepts used in connection with real estate exposures. Facilitating consistent interpretations of these concepts will aid comparability across jurisdictions and banks.

Real estate exposures – prudent value of property

Paragraph 50 "Prudent value of property", states that "…the value of the property must not depend materially on the performance of the borrower." The ABA would welcome some further guidance concerning the meaning of this phrase.

Real estate exposures – issue of multiple secured properties

The ABA seeks further clarity regarding the proposals in paragraphs 56 and 60 concerning situations where multiple properties secure an exposure. In particular, how a single exposure that is simultaneously secured by a residential property and a commercial property should be treated.

The ABA would also welcome further clarity beyond what is already provided in footnote 49 concerning units. For example, would the same principle apply to a subdivision of four separate dwellings?

Exposures to securities firms and other financial institutions

The ABA notes the Committee is proposing that securities firms and other financial institutions be treated like banks when they are subject to prudential regulation equivalent to banks.

Given the diverse nature of capital regulation that applies to securities firms and insurers across jurisdictions, the ABA would welcome the Committee's guidance in detailing which regulatory regimes would be considered equivalent to bank prudential regulation. This will assist banks to meet the Committee's objective of reducing variability in implementation across jurisdictions.

Guidance on the transposition of SME threshold

The ABA notes that the threshold for treating a corporate exposure as one to a small-to-medium enterprise is under €50 million in annual turnover. Could the Committee provide guidance for the transposition of this figure into other currencies by domestic regulators? This would prevent variability in implementation across jurisdictions.

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Implementation

The ABA welcomes the fact that the Committee intends to evaluate appropriate implementation arrangements, including transitional or grandfathering provisions where necessary, and will provide sufficient time for implementation, taking into account the range of other related reforms that have been, or are due to be, agreed.

The ABA requests the Committee also take into account the significant existing program of other interconnected and concurrent regulatory reforms already scheduled for implementation. National supervisors will need adequate time and flexibility to understand the interconnected nature of these international and domestic regulatory reforms to avoid unintended consequences and unnecessary costs.

Conclusion

The ABA appreciates the positive changes that the Committee has already made to its original proposals for revising the standardised approach to credit risk, but considers that additional refinements are still required to meet the Committee's objectives of providing a more risk sensitive standardised approach, whilst not increasing the overall level of capital.

The ABA would also like to express support for the submission of the International Banking Federation.

Thank you for taking our comments into consideration, and we look forward to further engagement on these issues.

Yours faithfully

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