The Standardised Approach for Credit Risk

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Abstract

The second consultative document for revisions to the Standardised Approach for Credit Risk was published in December 2015. It proposed significant revisions to the current credit risk capital framework and the first consultative document published in December 2014. There is a regulatory push to reduce the mechanistic reliance on external ratings, so that a bank's own due diligence and risk management drives risk weights and capital requirements. Significant revisions have been made to the treatment of different exposure classes. The key objective is to ensure that the Standardised Approach acts as a credible and comprehensive alternative to the Internal Ratings Based (IRB) approach. The proposals will have capital and operational impacts on banks.

Background

In December 2015, the Basel Committee on Banking Supervision (BCBS) introduced a second consultative document outlining revisions to the Standardised Approach for Credit Risk[1]. There is a push by regulators to harmonise the capital regime across credit, counterparty, market and operational risk through balancing simplicity and risk sensitivity, improving comparability through reducing RWA volatility across banks and jurisdictions, reducing excessive reliance on external ratings and ensuring that the standardised capital charge act as a credible alternative. There are also discussions as to whether to introduce the standardised capital charge as a floor to the internal model[2]. Further Quantitative Impact Studies (QIS) exercises are planned through 2016 in order to calibrate the Standardised Approach for Credit Risk framework.

Overview of Proposed Changes

The second consultative document for the Standardised Approach for Credit Risk has proposed significant revisions to the current framework. There is an objective to reduce the mechanistic reliance on external ratings, so that financial institutions are incentivised to undertake their own due diligence and risk management for risk weighting purposes. A comparison of the current approach to proposed changes, by exposure class, is provided below.

Exposure Class	Current Approach	Proposed Approach
Sovereigns	Mapping to external agency ratings and Export Credit Agency (ECA) scores	No change[3]
Public Sector Entities	One category less favourable risk bucket than sovereigns	Updated Individual and Sovereign Ratings
Multilateral Development Banks (MDBs)	Distinction between 0% Risk Weighted	Basic differentiation between the MDBs that have high-quality long-

[1] *The first consultative document for revisions to the Standardised Approach for Credit Risk was published by the Basel Committee on Banking Supervision (BCBS) in December 2014.*

[2] *A consultative document: reducing variations in credit risk weighted assets – constraints on the use of internal model approaches was published by BCBS in March 2016.*

[3] *The Basel Committee allows for two approaches for calculating sovereign risk weights to be made. In the first case, banks can rely on external ratings mapped to specific risk weights. In the second case, banks can use scores assigned to sovereign exposures by Export Credit Agencies (ECA). However, the methodology for calculating the ECA's scores must be aligned to the OECD-agreed principles and approved by the supervisor. Against this backdrop, only a limited number of sovereigns are assigned the ECA's scores. On the other hand, there are sovereign exposures that lack external ratings. Concerns also arise with the treatment of exposures to chosen supranational institutions, such as the Bank of International Settlements, the International Monetary Fund, the European Union and the European Central Bank, that receive a 0% risk weight. In 2014, the Governing report (Bankrupt Cities, Municipalities List and Map. Washington, USA: Governing Data) highlighted possible economic and financial repercussions stemming from the regulator's attempt to channel investments into the chosen supranational institutions.*

Exposure Class	Current Approach	Proposed Approach
	MDBs and other MDBs	term issuer ratings and other banks
Banks	One category less favourable risk bucket than sovereigns (long-term and short-term claim distinction) or credit assessment of banks	The External Credit Risk Assessment Approach (ECRA) for rated bank exposures and the Standardised Credit Assessment Approach (SCRA) for unrated exposures
Corporates	At national discretion, supervisory authorities may permit corporate claims to receive 100% Risk Weights without regard to external ratings	Credit assessment of individual exposures and preferential fallback-value for Corporate SMEs. There is also a 50% risk weight add-on for corporate exposures with a currency mismatch (where the currency of the loan is different to the borrower's main source of income). Banks need to apply a 50% risk weight add-on to unhedged exposures[4] with a currency mismatch
Specialised Lending	No separate treatment from the corporate exposures	Fixed risk weights for different types of specialised lending
Subordinated Debt, Equity and Capital Instruments	Investments in equity or regulatory capital instruments issued by banks or securities firms is risk weighted at 100%	250% risk weight to equity holdings
Retail Exposures	Risk-weighted at 75%, except for past-due items	Differentiation between the Regulatory Retail (75% Risk Weight) and Other Retail (85% Risk Weight) exposures
Residential Real Estate	35% Risk Weight	Loan to Value (LTV) Ratios and the characteristics of repayment (if materially dependent on cash flows generated by property)
Commercial Real Estate	100% Risk Weight as per Basel, in Europe 50% are applied (each national regulator may choose to apply its own risk weight)	LTV Ratios and the characteristics of repayment (if materially dependent on cash flows generated by property)
Acquisition, Development and Construction (ADC)	Treated as high-volatility commercial real estate with a 100% Risk Weight	Fixed 150% against exposures to land acquisition, development and construction finance

Impact on Financial Institutions

The Standardised Approach for Credit Risk proposals are likely to have a major impact on bank capital, with certain exposure types getting more punitive treatment. Banks should perform internal impact analysis early in addition to the QIS to understand how much capital will be consumed by each exposure type in its portfolio. This will help drive balance sheet composition decisions. In addition to capital, the new proposals will also have an operational impact to banks from a system, process, reporting and governance standpoint. The likely impact to capital requirements, by exposure class, is summarised below.

[4] Unhedged exposure is defined as an exposure to a borrower that has no natural or financial hedge against the foreign exchange risk arising from the currency mismatch.

Exposure Class	Likely Capital Impact
Sovereigns	No change
Public Sector Entities	Increase: Due to the conservative Risk Weights mapped to individual agency ratings
Multilateral Development Banks (MDBs)	Increase: Due to agency ratings not fully capturing operational capabilities of MDBs
Banks	Increase: Due to difficulties in discerning between the banks that exceed (GRADE A Bucket) or meet (GRADE B Bucket) minimum regulatory requirements
Corporates	Increase: However for several types of portfolio compositions there will be a low impact. The 50% risk weight add-on for corporates with a currency mismatch could lead to a significant RWA uplift, which would mean that lending to an unrated corporate obligor with a cross currency basis would receive the same risk weight as an exposure in default
Specialised Lending	Increase: Due to punitive fixed risk weights for specialised lending
Subordinated Debt, Equity and Capital Instruments	Increase: Due to the higher risk weights for equity holdings and the new weights assigned to subordinated debt that are now set to 150%
Retail Exposures	Decrease: Due to excluding past-due items and decrease in the Risk Weight for Other Items

Exposure Class	Likely Capital Impact
Residential Real Estate	Increase: Due to high risk weights for Loan to Value (LTV) buckets where repayment is materially dependent on cash flows generated by property
Commercial Real Estate	Not determined: Banks with commercial real estate and LTV will benefit from lower risk weights
Acquisition, Development and Construction (ADC)	Increase: Due to higher fixed Risk Weight

It is important for banks to do impact capital analysis as early as possible. Changes to balance sheet composition should be considered, based on an understanding of strategic levers that impact capital such as creditworthiness, exposure size, risk mitigation with collateral and guarantees and concentrations in retail segments, industrial sectors, geographic regions and single name obligors.

Banks need to consider the impact of the rules on their underlying systems and processes. With the need to perform due diligence on ratings and evidence changes across the lifecycle, there should be a focus on enhancing systems, so that completeness, accuracy and timeliness is optimised. Policies and procedures will need to reflect enhanced due diligence requirements and regulatory scrutiny. Failure to do so will likely lead to increased risk weights and more punitive capital requirements from the regulator.

Banks need to consider deal assessment and pricing in light of new capital requirements. Pre deal analysis tools are key in understanding the trade-off between revenue generated and capital consumption to help guide optimal pricing decisions. Cliff effects in capital need to be well understood and managed appropriately in order to provide stable pricing to customers.

Banks also need to consider how they report their credit exposures and capital for the purposes of Pillar III disclosures[5]. Having the right infrastructure that enables granular reporting and flexibility is important, as there is a move towards inclusion of hypothetical RWA, with the standardised approach to credit risk acting as a

[5] *See Pillar III Disclosure Requirements – Consolidated and Enhanced Framework consultative document published by BCBS in March 2016.*

credible and comprehensive alternative to the internal ratings based (IRB) approach.

Future Developments

The Basel Committee has planned further Quantitative Impact Studies (QIS) exercise through 2016 on order to better calibrate the framework for the Standardised Approach for Credit Risk. The implementation timeline is yet to be finalised but will be dependent on the range of other capital reforms that have been or in the process of being agreed by the committee (i.e. for market, counterparty and operational risks).

How We Can Help

Avantage Reply is a specialised management consultancy delivering initiatives in areas including credit risk capital requirements. Our capabilities include regulatory interpretation and implementation and business and technology change. We would be happy to discuss in more detail the Standardised Approach for Credit Risk and its implications on the business of your organisation.

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