KPMG

BASEL IV Credit Risk Standardised Approach (SA)

Considerations for Implementation

January 2021

The Basel Committee on Banking Supervision (BCBS) finalized the new Credit Risk – Standardized Approach (CR-SA) framework in December 2017. The implementation deadline was set as January 2022 but deferred by 1 year to January 2023 due to COVID-19. The HKMA has announced in March 2020 to follow this timeline and in November 2020 the HKMA released their consultation paper on the local implementation of the global standards.

1. Key facts about the new SA Framework:

Standardised Floor

The new standards introduce the standardized floor to limit the benefits of internal models. Banks capital requirements will be floored to a certain percentage of the standardized requirement, and this will be phased in over time rising from 50% at initial implementation (1st January 2023) to 72.5% by the 1st January 2028. This also means that all Banks (including IRB Banks) will need to implement the new standardized approach.

Revised Risk Weights

There have been a number of changes in the risk weights for certain asset classes. In particular, there is increased sensitivity for exposures secured by real estate, with greater emphasis placed on the loan-to-value ratio as the driver of the risk weight.

Due Diligence Requirements

The new SA Framework explicitly requires Banks to assess the risk of their exposures at origination and on an annual basis, which is in line with the HKMA's SPM requirements. However, Banks are also required to assess whether risk weights applied are appropriate and prudent. The HKMA has introduced this in their consultation paper and noted that they will consider the best approach to implement this requirement, potentially through amendments to the BCR and supervisory guidance.

2. Income-Producing Real Estate, the HKMA's "1 notch shift" and no loan-splitting

The new standards introduces significantly more sensitivity for risk weights of exposures secured by real estate, the following things should be noted, particularly regarding the local implementation proposed by the HKMA.

The new CR-SA introduces separate risk weights for general and income produced real estate exposures, both for residential and commercial real estate.

To account for the difference in LTV levels compared to other jurisdictions and the volatility of the local market the HKMA has proposed to adjust the risk weights by a "1 notch shift" for residential real estate.

The HKMA is proposing to not implement the "loan-splitting approach" which requires Banks to split exposure into two parts, each subject to a different risk weight.

		LTV < 50%	50% < LTV < 60%	60% < LTV < 80%	80% < LTV < 90%	90% < LTV < 100%	LTV > 100%
RRE that is not IPRRE	CR-SA	*20%*	*25%*	*30%*	*40%*	*50%*	*70%*
	HKMA Proposal	**25%**	**30%**	**40%**	**50%**	**70%**	**70%**
IPRRE	CR-SA	*30%*	*35%*	*45%*	*60%*	*75%*	*105%*
	HKMA Proposal	**35%**	**45%**	**60%**	**75%**	**105%**	**105%**

3. Impacts of the Revised Standardised Approach:

Capital Requirements: The most important impact will be to Bank's capital requirements. The HKMA found from their "local QIS" that reductions in risk weights improved the capital position for standardized Banks, however this may not incorporate the impact of the "1 Notch Shift" for residential mortgage loans. The ultimate impact will depend on Bank's portfolio mix and exposure profile.

Additional data requirements: The new CR-SA requires Banks to incorporate new data requirements into the assessment of the relevant risk weights. One key example is the "transactor" definition which will be used to determine the risk weight for regulatory retail exposures which will need to be incorporated into the CAR system if this is not already covered.

Business Model: Banks will need to assess the contribution of portfolios to capital requirements under the new CR-SA approach. There are portfolios where the capital requirements may encounter capital relief, while others will face a higher capital contribution. Banks will need to assess these impacts and whether they need to optimize their portfolios, product mix and lending strategy.

Defaulted Exposures: The revised SACR introduces a new defined term of "defaulted exposure", which means an exposure that is past due for more than 90 days; or an exposure to a "defaulted borrower". The HKMA will continue to apply the flat 150% risk weight, however this will be expanded to cover defaulted borrowers. Banks will need to ensure that they align the default definition in their CAR systems to cover the default events listed in CRE20.104 of the new CR-SA.

Off-Balance Sheet Items: The new CR-SA increases the CCF for unconditionally cancellable commitments ("UCCs") from 0% to 10% and commitments except UCCs receive a 40% CCF rather than the CCF being determined by the maturity of the exposure. Banks will need to assess the additional capital required for their existing commitments.

How KPMG can help?

It is important for banks to start understanding what the new Basel requirements mean in terms of risk exposure calculations, processes, data and systems. KPMG experts can assist you in the following areas:

- Assessing the implications of the interplay between the restrictions on the use of the IRB approach, the output floor and the revised Standardised Approach, and to assess corresponding business decisions. This can also be extended to cover the combined impact across risk types (credit, market and operational);
- Deciphering the quantitative impact of Basel IV. KPMG has developed Basel IV toolkits for quantitative impact studies and implementation support. These toolkits are well tested and can offer quick wins in this Basel IV journey;
- Undertaking a gap analysis assessment to understand what is changing and to use this information as an input to identifying the required data, systems and processes, and the implications of this for longer term planning and budgeting decisions. Any new data items that need to be captured may initiate larger scale changes or programs around IT architecture in order to deliver clearer data lineage and quality;

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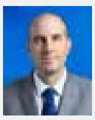
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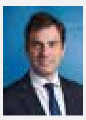
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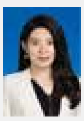
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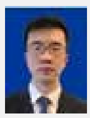
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