

In the detail...

Basel Committee Revised Proposals for the Standardised Approach to Credit Risk...



Exposures to banks

(a) External Credit Risk Assessment Approach (ECRA): for rated exposures of banks incorporated in jurisdictions that allow the use of external ratings for regulatory purposes, external credit ratings would be the primary basis to determine risk weights for rated exposures.

To reduce a mechanistic reliance on ratings, a bank using this approach would be required to perform due diligence to ensure that the external rating appropriately and conservatively reflects the credit risk of the exposure. If the due diligence assessment reflects higher risk characteristics than that implied by the external rating of the exposure, the bank would apply a higher risk weight for the exposure. Due diligence analysis should never result in the application of a lower risk weight than that determined by the external rating.

Banks' external ratings used for regulatory capital purposes should exclude government support.

As in the 2014 consultative document, short-term (up to three months) interbank exposures would receive a preferential risk weight.

Risk weight table for bank exposures under the ECRA (before due diligence):

External rating of counterparty	AAA to AA–	A+ to A–	BBB+ to BBB–	BB+ to B–	Below B–
'Base' risk weight (same as currently)	20%	50%	50%	100%	150%
Risk weight for short-term exposures	20%	20%	20%	50%	150%

(b) Standardised Credit Risk Assessment Approach (SCRA): In jurisdictions that do not allow the use of ratings for regulatory purposes, and for unrated exposures in all jurisdictions, banks would classify exposures into three different buckets (A, B and C).

Grade A: exposures to bank counterparties that have adequate capacity to meet their financial commitments (including repayments of principal and interest) in a timely manner, for the projected life of the assets or exposures, and irrespective of economic cycles or business conditions.

A counterparty bank classified into Grade A must exceed the published minimum regulatory requirements and buffers (eg SIB surcharge, capital conservation and countercyclical capital buffers) established by its national supervisor as implemented in the jurisdiction where the borrowing bank is incorporated.

A bank may classify an exposure to a higher risk grade even if it meets the above minimum criteria.

Grade B: exposures to bank counterparties that are subject to substantial credit risk, with repayment capacities dependent on stable or favourable economic or business conditions; or where a counterparty does not meet one or more of the applicable published buffers required by its national supervisor as implemented in the jurisdiction where the borrowing bank is incorporated.

Grade C: higher credit risk exposures to counterparties that have material default risks and limited margins of safety. For these counterparties, adverse business, financial, or economic conditions are very likely to lead, or have led, to an inability to meet its financial commitments.

At a minimum, a bank would apply a Grade C risk weight where the external auditor has issued a modified adverse audit opinion or has expressed doubts that the counterparty will be a going concern in its financial statements or audited reports; or where the bank counterparty has breached any of the published and binding minimum regulatory requirements determined by national supervisors as implemented in the jurisdiction where the borrowing bank is incorporated.

Risk weight table for bank exposures under the SCRA:

Credit risk assessment of counterparty	Grade A	Grade B	Grade C
'Base' risk weight	50%	100%	150%
Risk weight for short-term exposures	20%	50%	150%

If the exposure is in default it would receive a 150% risk weight.

Exposures to corporates

In jurisdictions that allow the use of ratings for regulatory purposes, external credit ratings would be the primary basis to determine risk weights for rated exposures. As in the case of exposures to banks, due diligence could result in a higher risk weight than that determined by ratings.

The criteria for eligibility of guarantors and financial collateral would also be primarily based on external ratings, as in the current approach.

Risk weight table for corporate exposures in jurisdictions that use external ratings for regulatory purposes:

External rating of counterparty	AAA to AA–	A+ to A–	BBB+ to BBB–	BB+ to B–	Below B–	Unrated
'Base' risk weight (same as currently)	20%	50%	100%	100%	150%	100%

In jurisdictions that do not allow the use of ratings for regulatory purposes, a lower risk weight of 75% would apply to certain corporates deemed to be 'investment grade'. Other exposures would receive a 100% risk weight. 'Investment grade' entities and debt securities issued by them, would be allowed as eligible credit risk mitigants.

In all jurisdictions, exposures to small and medium entities (SMEs) in the corporate exposure class would receive an 85% risk weight (SME exposures in the retail exposure class would continue to receive a 75% risk weight).

Consistent with the reintroduction of external ratings for risk-weighting exposures to banks and corporates, the Basel Committee also proposes to reintroduce the use of external ratings for specialised lending exposures. In particular, the Committee proposes to use issue-specific external ratings for project finance, object finance and commodities finance. The applicable risk weight would be determined by the same risk-weight table that would apply to general corporate debt exposures.

Where issue-specific external ratings are either not available or not allowed for regulatory purposes in a jurisdiction, the Committee proposes a flat risk weight of 120% for object and commodity finance exposures (irrespective of the counterparty's risk weight); and a 150% risk weight for the pre-operational phase of project finance, and 100% risk weight in the operational phase.

Exposures secured by real estate

The loan-to-valuation (LTV) ratio would be the main risk driver for risk weighting purposes, with a distinction between:

- Exposures secured by real estate where repayment is not materially dependent on rent/sale of the property; and
- Exposures secured by real estate where repayment is materially dependent on cash flows (ie rent/sale) generated by the property. Specialised lending (corporate) exposures assigned to 'income-producing real estate' under the IRB approach would be classified under this category.

In addition, banks would be required to consider the quality of the collateral (eg adequate valuation, finished property), the collateral's effectiveness (eg legal enforceability, seniority of lien), and other procedural aspects (eg required documentation) before assigning the minimum risk weights in the tables below, irrespective of the LTV ratio.

Residential real estate

Given the challenges of defining and calibrating a debt service ratio that can be applied consistently across jurisdictions, the Basel Committee has decided not to use this ratio as a risk driver. However, since evidence (within jurisdictions) still supports such a metric as a meaningful predictor of loan performance, the Committee proposes to require the assessment of the borrower's ability to pay as a key underwriting criterion.

Risk weight table for residential real estate exposures where repayment is not materially dependent on cash flows generated by property:

	LTV ≤ 40%	40% < LTV ≤ 60%	60% < LTV ≤ 80%	80% < LTV ≤ 90%	90% < LTV ≤ 100%	LTV > 100%
Risk weight	25%	30%	35%	45%	55%	Household 75% SME 85%

Risk weight table for residential real estate exposures where repayment is materially dependent on cash flows generated by property:

	LTV ≤ 60%	60% < LTV ≤ 80%	LTV > 80%
Risk weight	70%	90%	120%

Commercial real estate

Risk weight table for commercial real estate exposures where repayment is not materially dependent on cash flows generated by property:

	LTV ≤ 60%	LTV > 80%
Risk weight	Min (60%, RW of Counterparty) If the risk weight of the counterparty is lower than the preferential risk weight, a bank would apply the lower of the two risk weights	RW of Counterparty

Risk weight table for commercial real estate exposures where repayment is materially dependent on cash flows generated by property:

	LTV ≤ 60%	60% < LTV ≤ 80%	LTV > 80%
Risk weight	80%	100%	130%

Specialised lending real estate exposures defined as 'land acquisition, development and construction' (ie loans to companies or SPVs, unfinished property meeting the definition of specialised lending) would be risk weighted at a flat rate of 150%.

Other Retail

As in the December 2014 consultative document, there would be a flat 75% risk weight for 'regulatory retail exposures', and a 100% risk weight for exposures to individuals that do not meet all of the criteria for inclusion in the regulatory retail exposure class.

Exposures to retail SMEs that do not meet all of the criteria for the regulatory retail exposure would be treated as corporate SME exposures.

Investments in equity or regulatory capital instruments issued by banks or securities firms

The revised proposal here is for a 250% risk weight for equity holdings that are not deducted from regulatory capital, and 150% risk weight for subordinated debt and capital instruments other than equities below the threshold deductions.

Risk weight add-on for exposures with currency mismatch

Banks would be required to apply a 50% risk weight add-on to 'unhedged exposures' with currency mismatch, defined as an exposure to a borrower that has no natural or financial hedge against the foreign exchange risk arising from the currency mismatch. Under the revised proposals this would be extended to exposures to corporates.

Defaulted exposures

The unsecured portion of any defaulted exposure (other than residential real estate), net of specific provisions and partial write-offs, would receive a risk weight of 150%. As an exception, defaulted residential real estate exposures where the repayment does not materially depend on the cash flows generated by the property securing the loan would receive a risk weight of 100%.

The secured portions of defaulted exposures can be risk-weighted in accordance with the CRM framework provided that collateral and guarantees meet the eligibility requirements of the CRM framework.

Credit Risk Mitigation

Consistent with the 2014 consultative document, the removal of internal models and own estimates of haircuts for calculating capital requirements under the standardised approach are maintained.

Consistent with the current proposal for risk-weighting exposures to banks and corporates, it is proposed to retain external ratings in the CRM framework in order to promote risk sensitivity and reduce complexity.

For jurisdictions that do not reference external ratings in their regulations, the proposal introduces an alternative approach which, without explicitly referencing ratings, aims to limit the eligibility of financial collateral and guarantees to what is usually referred to as 'investment grade'. As a result, depending on whether external ratings are used in a given jurisdiction, the proposal contains two sets of eligibility criteria for defining financial collateral and eligible guarantors as well as two supervisory haircut tables.

Given the concerns that respondents raised about the lack of risk sensitivity of this approach for repo-style transactions, the Basel Committee proposes to revise the current formula under the comprehensive approach for these transactions to account better for diversification and correlation.

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