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27 March 2015

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Dear Sir / Madam

Revisions to the Standardised Approach for credit risk

The Banking Association of South Africa ("BASA") appreciates this opportunity to comment on the Basel Committee on Banking Supervision (BCBS) proposal to revise the BCBS standardised approach to credit risk to share our comments.

Our response to the Committee's specific questions has been captured on *Annexure A*; however we would like to provide some high level comments on the consultative document.

- ***We support a more risk sensitive approach to drive comparability***

We support the need for a more risk sensitive approach to the calculation of capital requirements for credit risk exposures to aid comparability, but are concerned that the new proposals seek to deliver a one size fits all approach without recognising that exposures in the same asset classes can behave differently in different jurisdictions, because of the operation of national law, accounting approaches or market conditions.

The requirement to default "no data available" risk weights to 300% is exceptionally onerous. Such a threshold might be the appropriate long term approach to encourage proper risk based data collection however; we strongly feel that this risk threshold (if retained), should be phased in over a multi-year period. In addition, applying the proposed risk drivers on banks that are not yet subject to Basel III makes the framework biased against banks in emerging markets as these are primarily not on Basel III and would thus be subject to the punitive 300% risk weight.

- ***The impact of the changes will be wide ranging***

The impact of the proposed revised standardised approach will be very wide ranging requiring banks to hold significantly higher levels of capital across the whole range of asset classes which will cause them to re-assess their business models, perhaps withdrawing from lending to elements of their current customer base that are more capital intensive. These proposed changes would likely result in more complexity in implementation as the required information may not be readily available in the level of detail required. The proposals may therefore lead to considerable IT investments.

- ***Credit ratings continue to have a role***

We also support a simplified approach to the calculation of credit risk but do not support the complete removal of the ability for banks to take external credit ratings into account. For the majority of asset classes external ratings performed as expected as a rank-ordering predictor of default. Whilst agreeing that banks should not mechanistically rely on ratings they should be permitted to retain the ability to use them as part of their overall credit risk assessment process.

Given that external ratings use more inputs than the two risk-driver approaches being proposed, they should be retained to calculate capital and the proposed risk drivers applied only as an alternative when external ratings are not available.

- ***The proposed changes are too important to be rushed***

We are concerned that the Committee is seeking to finalise its proposals with twelve months which we believe is too short a time frame for such a wide ranging revision.

We support the upcoming Basel monitoring exercise that will include QIS on credit risk SA. This will be used as an opportunity to complete in-depth analysis not only to gauge the impact but also to assess the appropriateness of the proposed risk drivers (as well as examine other risk drivers). However, sufficient time should be given to banks in doing the QIS since producing the needed data would likely be challenging.

In the attached annex we provide our responses to the questions contained in the consultation paper.

We thank you for taking our comments into consideration, and we look forward to future discussions on these issues.

Yours sincerely

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Gary Haylett
General Manager – Prudential

ANNEXURE A

BCBS Dec 2014 Proposal	BASA Comment
Bank Exposure	
Bank exposures would no longer be risk-weighted by reference to the external credit rating of the bank or of its sovereign of incorporation, but they would instead be based on a look-up table where risk weights range from 30% to 300% on the basis of two risk drivers: Capital adequacy & Asset Quality **Guide questions for commentary** • Comments on the use of CET1 and net NPA ratios? • Comments on possible inclusion of CET1 and net NPA ratios in Pillar 3 disclosures? • Do you believe the net NPA ratio is an effective measure for distinguishing a bank exposure's credit risk? What alternative asset quality measure, if any, should be considered by the Committee? • Comments on the proposed treatment for short-term interbank claims? • Views on the appropriateness of incorporating country risk as an additional risk driver? • Any suggestion on how to treat exposures to banks not subject to Basel III? Q1. What are respondents' views on the selection of the capital adequacy ratio? In particular, is the CET1 ratio superior to the Tier 1 ratio or the Leverage ratio? Do respondents agree that it is necessary to require calculations in accordance with Basel III in order to ensure a consistent implementation? Q2. Do respondents believe the net NPA ratio is an effective measure for distinguishing a bank exposure's credit risk? What alternative asset quality measure, if any, should be considered by the Committee? Q3. Do respondents have views on the proposed treatment for short-term interbank claims? Q4. Do respondents have suggestions on how to address these concerns on the treatment of	• This is strongly biased against emerging markets banks where public disclosures around Basel III type metrics is neither required by local regulation, nor by IFRS. The proposal cannot practically be implemented for exposures to banks in those markets or would be cost-prohibitive. A simplified approach should be considered for banks not subject to Basel III that might be anchored in a local rules capital ratio, or maybe even a leverage ratio calculation based on IFRS disclosures. • The proposed approach may promote contagion (pro-cyclicality) because it requires banks to hold more capital for exposures to each other as they become less well capitalized. This could exacerbate a "*race to the bottom*" during crises and downturns. The external rating would be a more stable metric. • The quality of disclosures is not really the same across jurisdictions, with some better than others. Thus, relying on disclosures as source for information on the same risk drivers (e.g. Net NPA) does not really guarantee comparability. • The use of NPA ratio in isolation could provide ambiguous outcomes, given the write-off policies of the bank and the specific country risk. It might be useful to consider the NPA in combination with the cost of credit ratio. The use of the NPA as an absolute ratio may also be misleading, given the type of banking entity, country risk and the performance of the specific peer group. • A key component missing is the impact of sovereign and parental support as well as country risk. • Given the above and the fact that country risk, along with other risk factors, is already taken into account in a bank's external rating, we

<table>
<tr><th>BCBS Dec 2014 Proposal</th><th>BASA Comment</th></tr>
<tr><td>exposures to banks? In particular, do respondents have views on how to treat exposures to banks not subject to Basel III in a consistent and risk-sensitive manner?</td><td>suggest that the external ratings-based approach be retained for bank exposures.
The proposed capital adequacy and asset quality risk drivers do not capture the risk profile of banks with significant trading book assets. We suggest adding another metric that would capture the volatility of revenue or the volatility of P&L in order to capture the risk of banks with trading portfolios.
The treatment of short-term interbank claims appears reasonable. The level of wholesale funding should, however, be considered as part of the risk classification.</td></tr>
<tr><td colspan="2">Corporate Exposure</td></tr>
<tr><td>Corporate exposures would no longer be risk-weighted by reference to the external credit rating of the corporate, but they would instead be based on a look-up table where risk weights range from 60% to 300% on the basis of two risk drivers: Revenue & leverage. Further, risk sensitivity would be increased by introducing a specific treatment for specialised lending
Guide questions for commentary
Comments on the use of revenue and leverage as risk drivers?
Views on the idea to include material off-balance sheet exposures in total assets for purposes of calculating the leverage ratio?
What are implications of the proposed risk drivers and the use of fixed bucketing thresholds for all jurisdictions and different types of corporates, including SMEs? Can we suggest alternative risk drivers?
How to address potential cliff effects for exposures to small entities that no longer qualify as regulatory retail exposures and therefore are treated as low-revenue corporate exposures?
Comments on proposed treatment for specialized lending?
Comments on the proposed treatment of subordinated debt and capital instruments?</td><td>Revenue thresholds will not be well calibrated for emerging market environments such as African countries. In addition, disparity between countries is likely to be observed. It is suggested that these constraints be well considered given that QIS results may not give sufficient granularity of information to calibrate for lower revenue thresholds.
The data required, although typically used as part of credit underwriting decisions, is unlikely to be held consistently in automated and consistently calibrated manners.
The definition of revenue should be clarified with particular respect to inclusion or exclusion of subsidiaries, holding companies, and sister companies.
This may prove to be unclear for companies with cross-border activities/operations and/or complicated holding structures.
Revenue should ideally be seen in the context of operating margins.
Revenue may also not be an accurate indicator of risk where the counterparty is exposed to diminishing reserves.
Detailed guidance will need to be provided around what items are included in debt (i.e. contingent liabilities, guarantees, pension fund shortfalls, operating lease liabilities etc.).</td></tr>
</table>

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Q5. Do respondents have views on the selection of risk drivers and their definition, in particular as regards leverage and the incorporation of off-balance sheet exposures within the ratio? Would other risk drivers better reflect the credit risk of corporate exposures? Q6. Do respondents have views on the appropriateness of the proposed treatment, especially with regard to SMEs? And about the more lenient treatment for start-up companies? Q7. Do respondents think that the risk sensitivity of the proposal can be further increased without introducing excessive complexity? Q8. Do respondents agree that introducing the specialised lending category enhances the risk sensitivity of the standardised approach and its alignment with IRB?	• The leverage ratio also needs to be anchored to reflect the industry and country risk. Internal model builds have shown that the Debt: EBITDA is a better indicator of leverage than Total Assets to Total Equity. • 300% for lack of data appears to be punitive for jurisdictions (emerging and frontier markets) where the typical corporate is a smaller company and disclosure standards differ. In these jurisdictions, obtaining leverage and revenue data on an annual basis may be impossible for many corporates. Suggestion is to require financial information to be updated every other year or every three years only. • The specialised lending cap will negatively impact developed market exposures. • For subordinated debt, where the ratios are based on consolidated numbers, how would lending into the Holdco as subordinated be shown? • A key factor that is not incorporated and that is crucial for Emerging Market portfolios is parental support and country risk. • Although the factors may be readily available for corporates, this is not necessarily the case for asset classes such as NBFI's and Local Governments where we currently do not have this information readily available. • We suggest more granularities of the revenue buckets and greater differentiation for leverage ratios.
Retail Exposure	
The retail category would be enhanced by tightening the criteria to qualify for the 75% preferential risk weight, and by introducing a fall back subcategory for exposures that do not meet the criteria. **Guide questions Guide questions for commentary** • Any suggestions and evidence on, how to increase the risk sensitivity of the regulatory retail exposures treatment, either by	• For improved alignment between IRB and the standardised approach we suggest more granularity and similar asset classes as for retail exposures under the IRB approach. • The risk sensitivity of regulatory retail exposures could be increased by considering standard risk drivers such as previous and current utilisation/proportion of loan repaid, product type, and collateral. Empirical evidence confirms that all these drivers provide a

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differentiating certain product subcategories for which a specific risk weight may be appropriate; or by suggesting simple risk drivers that could be used to assess the risk of all retail exposures? Q9. Can respondents suggest, and provide evidence on, how to increase the risk sensitivity of the regulatory retail exposures treatment, either by differentiating certain product subcategories for which a specific risk weight may be appropriate; or by suggesting simple risk drivers that could be used to assess the risk of all retail exposures?	meaningful differentiation of risk. These drivers should be available for most jurisdictions and at most financial institutions. • In addition to risk sensitivity, the proposed approach corrects the potential misalignment of incentives that could otherwise result from the increase of CCF for unconditionally cancellable exposures from 0% to 10% proposed by the Committee.
Exposures Secured by Residential Real Estate	
Exposures secured by residential real estate would no longer receive a 35% risk weight. Instead, risk weights would be determined according to a look-up table where risk weights range from 25% to 100% on the basis of two risk drivers: (a) Loan to value = total amount of the loan : value of the property (b) Debt service coverage (DSC) = debt service payments (including principal and interest): borrower's total income (net of taxes) over a given period **Guide questions for commentary** • Comments on the use of LTV and DSC ratios as risk drivers, their definitions, etc.? • Comments on the proposal to calculate the value of the property (for LTV ratio purposes) and the DSC ratio at origination only? Q10. Do respondents agree that LTV and/or DSC ratios (as defined in Annex 1 paragraphs 40 and 41) have sufficient predictive power of loan default and/or loss incurred for exposures secured on residential real estate? Q11. Do respondents have views about the measurement of the LTV and DSC ratios? (In particular, as regards keeping the value of the property constant as measured at origination in the calculation of the LTV ratio; and not updating the DSC ratio over time.) Q12. Do respondents have views on whether the use of a fixed threshold for the DSC ratio is an	• The definition of 'borrower's total income (net of taxes) is subject to interpretation and would have implications on the use of the DSC ratio. • Debt service ratios are very difficult to obtain in certain countries, with the exception of at origination. We therefore agree that the calculation should only apply at origination if it is applied. • It should be noted that credit bureaus and credit reference agendas are not in existence in most emerging markets and are unlikely to be for years so this should not be considered as a likely source of information in those jurisdiction. • Measurement of total income in an emerging market environment with significant informal sector or self-employed individuals may be impossible; thus prejudicing developmental objectives to deepen housing access. • Emerging markets are yet to experience the cyclicality experienced in other jurisdictions with regards to property values. On the contrary residential prices continue on the upside due to supply and demand thus implying that keeping the value of the property constant as at origination may be inaccurate. • Suggestion that banks be allowed to update property values and loan values as and when possible. • Caution that results need to be well-calibrated

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appropriate way for differentiating risks and ensuring comparability across jurisdictions? If not, what reasonably simple alternatives or modifications would respondents propose while maintaining consistent outcomes? Q13. Do respondents propose any alternative/additional risk drivers for the Committee's consideration in order to improve the risk sensitivity in this approach without unduly increasing complexity?	for emerging markets because the proposal may have a dampening effect on the important goal of improving housing loan availability in those jurisdictions. • What happens in the cases of dual income and joint acquisitions?
Exposure Secured by Commercial Real Estate	
Exposures secured by commercial real estate are subject to further consideration where two options currently envisaged are: (a) treating them as unsecured exposures to the counterparty, with a national discretion for a preferential risk weight under certain conditions; or (b) determining the risk weight according to a look-up table where risk weights range from 75% to 120% on the basis of the loan-to-value ratio. **Guide questions for commentary** • Which of the two options above is viewed as the most suitable for determining the risk-weight treatment for exposures secured on commercial real estate? • What other options might prudently increase the risk sensitivity of the commercial real estate treatment without unduly increasing complexity? Q14. Which of the two options above is viewed as the most suitable for determining the risk-weight treatment for exposures secured on commercial real estate? Q15. What other options might prudently increase the risk sensitivity of the commercial real estate treatment without unduly increasing complexity?	• We suggest further granularity in terms of the LTV thresholds, maybe similar to that of residential mortgages • Calibration should take into account the nature and inherent riskiness of the asset class in country and other jurisdictions where the asset class has performed relatively well over time. • We believe that Option A is completely inappropriate and not based on actual experience when combined with appropriate risk management and controls. Option B also has significant weaknesses. Under Option A, credit quality is the only consideration while under Option B, the focus is on the value of collateral in relation to the outstanding amount of the loan. We believe that it is important for both credit quality and collateral to be considered and there are no options that offer this possibility. There should be. ◦ Option A focuses on counterparty default risk and assumes recovery on the real estate is similar to unsecured exposures. The treatment of commercial real estate as unsecured with a maximum risk weight of 300% would promote the reduction of lending to commercial borrowers or increase the interest rate on funds borrowed. As a suggested improvement, consideration should be given that based on an LTV threshold, the corresponding unsecured corporate risk weight would be

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	reduced by a fixed %. • Option B focuses on expected recovery based on LTV. Given our earlier comments on LTV, this risk factor may also not be the best choice for risk weight measurement. In addition the floor of 75% risk weight under Option B is too high, and not reasonably comparable with IRB measures. The appropriateness will ultimately depend on the RW% levels. Under both options, the same issues on risk drivers noted in responses to other questions apply. • Based on the proposed definitions, i.e. primary source of repayment is not from income generated by the real estate collateral, the contemplated CRE would be mostly owner occupied real estate. The risk weights for exposures secured by commercial real estate are a very narrow range and there is also no consideration for the nature of the loan (e.g. real estate development, income producing real estate, owner occupied) or the quality of the collateral (e.g. land vs income producing, residential, retail, office, etc.). Rather than having to choose between two options, one of which is more along the "PD" dimension and the other "LGD", the final table should take both into consideration as this is aligned with banks' internal assessment of risk. • We suggest using some real estate market cycle indicator in individual countries/regions (the real estate market in different jurisdictions could be very different at the same point of time). Consideration should also be given to the nature of the loan and the quality of the underlying real estate.
Credit Risk Mitigation	
The credit risk mitigation framework would be amended by reducing the number of approaches, recalibrating supervisory haircuts, and updating corporate guarantor eligibility criteria.	• We agree that the add-on should be limited to retail exposures given the borrower is most probably not hedging these exposures. However, consideration should be given to ensuring the add-on factor is lower for less

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Guide questions for commentary • Comments on the proposed "investment grade" criterion for eligible financial collateral? • Comments on the recalibrated haircuts? • Comments on the proposal to remove references to ratings from the supervisory haircuts table? • Views on the implications and possible impact of eliminating the exemption from the 20% risk weight floor for repo and OTC derivative transactions with "core market participants"? Q16. Do respondents agree that a risk weight add-on should be applied to only retail exposures and exposures secured by residential real estate? What are other options for addressing this risk in a simple manner?	volatile, more widely traded currencies**.**
Other	
Off-balance sheet exposures Propose aligning the CCFs under the current standardised approach with those applied under the foundation IRB approach, except in the case of the 0% CCF (i.e Commitments that are unconditionally cancellable at any time without prior notice, or that effectively provide automatic cancellation due to deterioration in borrower's creditworthiness) for which the proposed CCF is 10% (previously 0%). **Guide questions for commentary** Comments on the revised CCFs? Q17. Do respondents consider the categories for which a CCF is applied under the standardised approach to be adequately defined? Q18. Do respondents agree that instruments allocated to each of the CCF categories share a similar probability of being drawn and that the probabilities implied by the CCFs are accurate? Please provide empirical support for your response.	• Greater differentiation in categories could allow for better risk sensitivity. We would welcome more differentiation if it would result in lower risk-weighting of certain off-balance sheet items. Additionally, retail categories LOC, Credit Card, and HELOC should be explicitly included as categories under the revised standardised approach, since the drawn down on retail exposures is difficult to compare with highly monitored commercial/corporate exposures. Commitments with future drawdowns subject to certain conditions to be met by the obligor should also be covered. As noted above, we also find the proposal to increase the risk weighting from "20% and 50%" to "75%" in Table 1 to be very punitive. • We agree in principle with the Committee's proposal to increase CCF for unconditionally cancellable commitments for Retail exposures and Retail Mortgages (HELOC) from 0% to 10%, and with the rationale provided by the Committee. In particular this would better align the standardised approach treatment with the Advanced IRB approach, where CCF is estimated based on the historically observed

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	additional drawings prior to default, which are not all zero. • However in order to accurately reflect the true risk of these commitments, not only their CCF but also their risk weight under the standardised approach should be adjusted to better align with those under the Advanced IRB approach. Otherwise, the risk weights for the revolving retail exposures (including both their drawn and undrawn portions) as a percentage of their outstanding balances would be misaligned with the actual risk of these exposures
Past-due loans The Committee will continue to consider the best way of applying risk weights to the additional risk resulting from insufficient provisioning or higher unexpected losses of past due loans. Alternatives could be a flat risk weight for all past-due exposures, or an add-on to the applicable risk weight. **Guide questions for commentary** Views on the appropriate treatment of past-due loans? Q19. What are respondents' views on the alternative treatments currently envisaged for past-due loans?	• We agree with the Committee that risk weights should reflect the level of provisions. An add-on which would vary based on a function of the amount of provisions would appear to be more risk-sensitive. • We propose using the sliding scale instead of the flat risk weight as the application of a flat risk weight could potential disincentives banks from raising provisions • A flat risk weight would ensure that there is a minimum capital level especially for cases where provisions may not have been assessed yet or may be insufficient. The latter component of the calculation recognises that banks have already established provisions and add-on accounts for uncertainty in the provisioning. An add-on that varies with provisions is reasonable.
Exposures to multilateral development banks (MDBs) The current 0% risk weights applied to claims on (MDBs) based on an MDB's external credit rating remains unchanged. For the remaining population of MDBs, the Committee proposes that the fall back treatment for claims on MDBs should be as corporate exposures. **Guide questions for commentary** Comments on the treatment of exposures to MDBs? Q20. Do respondents agree with the proposed	• We believe that the proposed risk weight treatment for MDBs is reasonable. We feel the MDBs should be considered a unique subset of corporates while retaining the current risk weights. For consistency, the regulations need to be clear that the 0% preferential treatment applies under the IRB framework. • We need to understand what exposures would be classified as "Other Assets" or "Other Credit-Risk-weighted Assets".

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treatment for MDBs?	
Other assets (excluding those subject to their own capital requirement framework such as SFTs, OTC derivatives, securitization, and equity investments in funds) – retain the existing risk weight of 100% **Guide questions for commentary** Comments on the treatment of other assets? Q21. What exposures would be classified under "Other assets"? Is a 100% risk weight appropriate? (Please provide evidence where possible). Other Q22. What are respondents' views on the above alternative ways to define eligible financial collateral? Q23. What are respondents' views on the recalibrated supervisory haircuts shown in Table 4? What are respondents' views on how to eliminate references to ratings from the supervisory haircuts table? What could be the implications of eliminating references to external ratings? Q24. What are respondents' views on the proposed corporate guarantor eligibility criteria?	• We suggest that the classification of items as other assets be consistent with IFRS accounting rules. We believe that the Other Assets category should be similar to the current approach. There will need to be further clarification of the securitisation exposure rules because the new standardised guidelines do not come into force until 2018. Until then, would these exposures be subject to the proposed 100% risk weight? • Given the substantial volume of financial collateral, it will not be feasible to complete the necessary due diligence to assess the risk of default and if full/timely repayment is expected for each issuer of the financial collateral. The concept of "investment grade" appears reasonable but we believe that it would be difficult to implement operationally. • If agency ratings are replaced, any alternative approach will need to be aligned with the approach for determining risk weights for exposures to like issuers/counterparties in other portfolios. • We are supportive of more granular maturity buckets for supervisory haircuts in Table 4 as this would reflect inherent risk better. We also prefer the ratings-based table over the issuer/RW-based table. The latter seems to be less risk sensitive than the ratings-based approach and would require additional work to build out the infrastructure with little apparent benefit. • We do question whether the increased haircuts due to recalibration in issuer rating categories of AAA and Main index equities are required. • The key determinant for guarantor eligibility should be based on the absence of any economic relationship or interdependence between the borrower and guarantor and if there is true economic benefit expected from

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	the guarantee. Thus, eligible guarantors should not be limited to non-corporates.

Additional comments

Subordinated debt, equity and other capital instruments

Public and private equity holdings defined in paragraph 352 of Basel text are not for the purpose of capital gains and should not be risk-weighted at 300% or 400% which we assume is designed for reflecting price fluctuation risks. Some banks hold those instruments for the purpose of long-term growth and development of issuers and expanding comprehensive business relationship with them. So such equity holdings should be positioned as financing equivalent to long-term loans where is can be shown that they are not being held for trading purpose. Where this is the case they should be risk-weighted as a corporate exposure, not to reflect fluctuation risks.

We propose that specific calculation method for those exposures should be as described below:

- They should be risk-weighted based on risk weight table for corporate exposures, with the risk weight doubled, reflecting the difference of LGDs between ordinary debt and equities. The LGD for equities is 90% and it is twice as high as that for ordinary debt, 45%, under Foundation IRB.
- Subordinated debt should be risk-weighted according to the creditworthiness of the corporate exposure, not at a flat 250%. The reason for applying 250% risk-weight to financial institution equities is to reduce the risk of double gearing between banks causing destabilisation of financial system. Therefore it would not make sense to apply the 250% to corporate equities.
- We propose that such investments will be risk-weighted based on risk weight table for corporate exposures with the risk weight multiplied 1.67 times. The 1.67 takes into account the difference of 75% LGD for subordinated debt and 45% LGD for ordinary debt in Foundation IRB.