Finance Norway

Basel Committee on Banking Supervision
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Finance Norway's response to the BCBS consultation on Revisions to the Standardised Approach for credit risk

Finance Norway welcomes the opportunity to express the views of the Norwegian banking industry on the Basel Committee's consultation on revisions to the standardised approach for credit risk.

In our view, a fundamental review of the standardised approach for credit risk is timely, and needed to support good risk management in the banking industry. However, to achieve the intended effect it is crucial that risk weights reflect the inherent riskiness of exposures. Risk parameters should thus be thoroughly tested and calibrated against empirical evidence. Moreover, increased risk sensitivity beyond the committee's proposals is necessary for several exposure classes, e.g. corporate exposures, mortgages and bank exposures. In addition, it is essential that the revised approach provides appropriate incentives and that risk is treated equally across exposure classes.

Finance Norway fully supports the Committee's initiative to reduce national discretion. It is of fundamental importance that the same basic methodologies are applied for the calculation of RWA. If not, regulatory standards will generate excessive dispersion and impair cross-border comparability of capital adequacy. Consequently, a revised standardised approach should be identically implemented across jurisdictions, without leeway for national discretion, in order to obtain a level playing field.

Furthermore, we support the Committee's objective that revisions should not increase overall capital requirements under the standardised approach. However, it seems likely that higher capital requirements could become the result given the current proposal.

Comments by asset class and responses to BCBS questions

Bank exposures

In our view, applying external credit ratings remain a suitable approach when assessing the riskiness of exposures to banks. External credit ratings provide comprehensive risk information and other risk drivers should only be used when credit ratings are unavailable.

(Q1.) When it comes to selection of the suitable capital adequacy ratio, we would emphasise the Committee's identification of RWA inconsistencies across banks and jurisdictions. Since undesirable RWA dispersion influences risk-weighted capital adequacy ratios, we suggest using both the CET 1 ratio and the leverage ratio as risk drivers.

Furthermore, to strengthen risk sensitivity the Committee should introduce further low-risk granularity for bank exposures (so that banks with high CET 1 ratios, e.g. above 14%, receive a lower risk weight than implied by the current table).

The proposal does not explicitly address covered bonds, which have a preferential claim and are accordingly less risky than other exposures to banks. Covered bond exposures should thus have a preferential treatment according to the principles in the current European regulation.

Corporate exposures

(Q5.-Q7.) Finance Norway is of the opinion that SME exposures attain risk weights that are too high relative to underlying risk. Risk factors that characterize SMEs often differ from those that distinguish large firms.

One possible solution would be to divide the class for corporate exposure into two categories; one for large companies and one for SMEs. For large companies we consider that external credit ratings represent a superior risk measure, as they take a wide number of risk factors into account.

For businesses without external credit ratings, appropriate risk drives must apply, and regulatory standards must ensure a sufficient degree of risk sensitivity. The Committee should carefully consider other risk parameters for profitability, such as e.g. return on assets or return on equity. The leverage parameter should also be evaluated further, as leverage ratios vary across industries. Furthermore, granularity of risk weights should be widened beyond the Committee's proposal, resulting in lower risk weights for low-risk firms and more granular risk-weight buckets for corporates with the highest risk. This would better reflect exposures' risk and thus support good risk management.

Claims secured by real estate

(Q10.) In our view, LTV and the DSC ratios are appropriate risk parameters for mortgages. Still, mortgage risk weights should be more differentiated based on a thorough calibration. Compared to the Committee's proposal, risk weights should be lower at low LTV buckets and higher at high LTV buckets to properly capture actual risk.

(Q11.) The LTV ratio should be calculated using updated property valuations in jurisdictions where such value updates are possible. Keeping the property value constant has several shortcomings:

- Firstly, a constant value will reduce risk sensitivity, in contradiction to the objective of the revisions. The LTV is a key risk variable, and an outdated LTV gives an incorrect measure of risk.
- Secondly, a constant property value could weaken competition in the mortgage market. Falling house prices will cause a lock-in effect of borrowers since switching of banks result in a higher LTV, capital requirement and lending rate (ceteris paribus). In a market with rising house prices, the opposite effect will occur. If the customer switches bank, the capital

requirement related to the mortgage will fall. The customer will thus have an incentive to refinance or switch bank.
- Thirdly, this type of regulation involves operational costs. Risk depends on concurrent collateral values and risk calculations should thus be based on updated property values. Operating with two sets of property valuations, one updated for risk management purposes and one outdated for regulatory purposes, is unnecessary.

Moreover, the Committee's proposal implies an incentive to increase the loan maturity and/or choose interest-only mortgages to bring the DSC value below 35%. DSC calculations should therefore be based on standardised parameters, such as e.g. a fixed repayment period. The methodology should be internationally harmonized.

Subordinated debt, equity and other capital instruments

In our view, there is an inconsistency between the treatment of insignificant and significant investments in the financial sector. Significant investments (ownership > 10%) receive a 250% risk weight, while insignificant investments attain 300% or 400% risk weight. Based on Norwegian experience, we question whether this differentiation is justified.

Also, a risk weight of 300-400% on equities may impede restructuring as banks will be reluctant to convert debt into equity.

Furthermore, the proposal does not differ between subordinated loan capital and AT1 hybrid instruments (e.g. perpetual subordinated loan capital securities). Hybrid instruments are more risky than subordinated loan capital as these have junior priority compared to the latter, which must be reflected in a risk-sensitive framework.

Lastly, individual shares are given the same risk weights as mutual funds. Mutual funds are considered less risky due to diversification, and should accordingly obtain a lower risk weight than individual shares.

Yours sincerely

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