Article 2

Corporate Exposures

Summary

The main changes introduced by the Basel IV revisions can be summarised as follows:

1. **SME's:** A separate risk weight of 85%, lower than the 100% risk weight applicable to large unrated corporates, is applied to unrated exposures to SME's. Small and Medium Enterprises are defined as corporates with a maximum turnover of € 50 million. This aligns the treatment of SME's to their treatment under the IRB.

2. The **risk weights** associated with external ratings are **recalibrated**. The recalibration facilitates the access of standardised banks to some of the lower risk weights, which it brings more in line with the IRB risk weights.

3. If banks are incorporated in jurisdictions that do ***not*** allow the use of external ratings for regulatory purposes, they are permitted to assign a 65% risk weight to the corporates that they identify as "**investment grade**"**.**

4. Three categories of **"Specialised lending"** (Object finance, Commodity finance and Project Finance) are "imported" from the IRB Approaches.

5. If the exposure is a claim on a corporate but "**related to real estate"** then new, separate rules apply, which will be covered in a future article. Commercial real estate does not have a separate treatment under the current SA rules. The 100% risk weight applies.

Detailed Review

I. Current Basel II rules- a refresher

Under Basel I *all* corporate exposures were assigned the same 100% risk weight.

Since the minimum amount of capital required by Basel I (and Basel II-III) is equal to 8% of the risk weighted assets of the bank, this meant that for a loan of 100 million to a corporate, a bank had to allocate an amount of capital of at least 8 million: 100 million x 8% x 100% = 8 million.

The main innovation of the existing Standardised Approach was to allow banks to use external ratings (i.e. the ratings of credit agencies such as Moody's, S&P etc.) to access the lower risk weights associated with high(er) credit ratings, as shown in the table below.

Credit assessment	AAA to AA-	A+ to A-	BBB+ to BB-	Below BB-	Unrated
Risk weight	20%	50%	100%	150%	100%

This means, as an example, that the capital required for a loan of 100 million to a company rated AA, which was 8 million under Basel I as shown above, is now 100 million x 8% x 20% = 1.6 million.

Because of the lower risk weight of 20%, the capital requirement is divided by 5 and, accordingly, the return on that loan is multiplied by 5.

Basel II, again to encourage banks to move away from the Standardised Approach and use the IRB Approaches instead, deliberately set the bar very high: only exposures to corporates rated A- or better (there are not that many of these) enjoy a risk weight lower than 100%.

Even exposures to BBB- to BBB+ corporates, which *are* investment grade, are still risk-weighted 100%.

And so are unrated exposures, which of course, on a worldwide basis, vastly outnumber the rated ones. This is particularly true of emerging markets, where the pool of rated companies is limited.

II. Basel IV

In order to "enhance the credit risk sensitivity of the Standardised Approach", the corporate exposure class now differentiates between "General corporate exposures" and "Specialised lending exposures".

1. General corporate exposures

There are now in effect 3 different regimes:

A. Jurisdictions where the use of external ratings is allowed.

Banks incorporated in a jurisdiction that allows the use of external ratings must assign risk weights according to the table below, which is extracted from the Basel IV Revisions.

What has changed is the recalibration of the risk weights. Contrary to the current table discussed above, exposures to corporates rated BBB- to BBB+, which are investment grade, are assigned a 75% risk weight instead of the current 100%.

This risk weight is also more closely aligned to the risk weight produced by the IRB Risk Weight Function for a credit of similar quality, which of course was the objective.

Risk weight table for corporate exposures

Jurisdictions that use external ratings for regulatory purposes Table 10

External rating of counterparty	AAA to AA–	A+ to A–	BBB+ to BBB–	BB+ to BB–	Below BB–	Unrated
"Base" risk weight	20%	50%	75%	100%	150%	100%

B. Jurisdictions where external ratings are not allowed

For corporate exposures of banks incorporated in jurisdictions that do **not** allow the use of external ratings for regulatory purposes, banks must assign a 100% risk weight to all corporate exposures, with the exception of exposures to corporates identified by the bank as **"investment grade"** in which case the risk weight is **65%.**

The Revisions define an investment grade corporate as: "a corporate entity that has adequate capacity to meet its financial commitments in a timely manner and its ability to do so is assessed to be robust against adverse changes in the economic cycle and business conditions. When making this determination, the bank should assess the corporate entity against the investment grade definition taking into account the complexity of its business model, performance against industry and peers, and risks posed by the entity's operating environment. Moreover, the corporate entity (or its parent company) must have securities outstanding on a recognised securities exchange."

In other words, apart from the stock exchange listing requirement, all a bank has to do to qualify for this treatment is to be able to conduct a well informed and argued credit analysis to justify its decision.

Nothing extraordinary here. Banks, standardised or not, should, indeed must, be able to conduct proper credit analyses.

Nevertheless, this is the first time banks using the Standardised Approach are allowed to use their own judgement to rate a corporate.

What you may find intriguing, or even disappointing, about this new provision however is its limited scope of application.

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Why indeed restrict it to jurisdictions where the use of external ratings is *not* allowed?

Unrated exposures vastly outnumber rated ones even where external ratings *are* allowed, so why not apply this provision to all unrated exposures, wherever they are? And why create a different treatment solely for “investment grade” corporates and not a scale of several risk grades, good and bad?

More broadly, how does this limitation reconcile with the Basel Committee’s stated policy to grant more discretion to banks in the revised Standardised Approach?

Looking at the consultations that preceded the publication of the Basel IV Revisions, I think that the discretion granted to banks by this provision is less an example of a change in policy than the confirmation of the BCBS’ capitulation on that front.

The original intention of the Basel Committee was in fact to eliminate the use of external ratings altogether. They had become unpopular after the financial crisis and, perhaps more importantly, were perceived as too much of a mechanical substitute for credit analyses.

All valid concerns.

So, the proposal was to replace them with 2 metrics: revenues (Turnover) and a leverage ratio (Assets to equity), which the Basel committee thought had predictive value, at least statistically.

Perhaps surprisingly the feedback from the industry was negative, on the grounds that the calculation of the metrics by banks would have created inconsistencies between jurisdictions.

Given the very basic nature of the calculations in question, I doubt very much it would have been the case, at least not to the extent of disrupting the comparability of ratings and risk weights.

The Standardised Approach might have taken a different turn and ended up looking very different but what prevailed in the end, with some irony, is the pretty dim view banks seem to take of their own analytical abilities.

Comparability and uniformity won the day and the pendulum swung all the way back to external ratings, except in jurisdictions that could not/did not want to use them.

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C. SME's

For unrated exposures to corporate SMEs (defined as "corporate exposures where the reported annual sales for the consolidated group of which the corporate counterparty is a part is less than or equal to *€50 million* for the most recent financial year"), an **85% risk weight** will be applied.

Under the IRB Approaches, the same SME's enjoy a specific Risk Weight Function (RWF), which generates lower risk weights than the RWF used for large corporates. This favourable treatment is now replicated in the SA.

Note that the new rules applicable to retail exposures specifically allow banks to include these exposures, which are ***corporate*** exposures, in their "qualifying ***retail*** portfolios", provided the qualifying criteria are met. These criteria are reviewed in the article dedicated to retail exposures.

Qualifying retail exposures are assigned a **75% risk weight**, better than the 85% "normal" SME risk weight.

2. Specialised lending exposures

These categories are similar to the IRB Specialised Lending categories, which are "imported" into the Standardised Approach.

Currently these exposures are treated as corporate exposures, which means that unless they take the form of an investment in an instrument (E.g. bond) with an *issue-specific* external rating, the applicable risk weight is 100%.

A. <u>Categories</u>

Specialised lending cannot be **related to real estate,** which is treated separately under Basel IV.

The exposure is typically to **an entity** (often a special purpose vehicle (SPV)) that was created specifically to finance and/or operate physical assets; the borrowing entity has few or no other material assets or activities, and therefore little or no independent capacity to repay the obligation, apart from the income that it receives from the asset(s) being financed.

Specialised lending comprises the following three subcategories of specialised lending:

(i) **Project finance** refers to the method of funding in which the lender looks primarily to the revenues generated by a single project, both as the source of repayment and as security for the loan.

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(ii) **Object finance** refers to the method of funding the acquisition of equipment (e.g. ships, aircraft, satellites, railcars, and fleets) where the repayment of the loan is dependent on the cash flows generated by the specific assets that have been financed and pledged or assigned to the lender.

(iii) **Commodities** finance refers to short-term lending to finance reserves, inventories, or receivables of exchange-traded commodities (e.g. crude oil, metals, or crops), where the loan will be repaid from the proceeds of the sale of the commodity and the borrower has no independent capacity to repay the loan.

B. Treatment

If external issue-specific ratings are allowed and available, the Table 10 (See above) used for general corporates applies.

This provision only clarifies the current regime.

If external issue-specific ratings are not allowed or not available:

- Object and commodities finance exposures: 100% risk weight;

  This new provision in fact changes nothing.

- Project finance exposures. This is new:

  - 130% during the pre-operational phase
  - 100% during the operational phase
  - 80% for operational phase and deemed to be high quality

“Operational phase” is defined as the phase in which the entity that was specifically created to finance the project has (i) a positive net cash flow that is sufficient to cover any remaining contractual obligation, and (ii) declining long term debt.

A “high quality” project finance exposure refers to an exposure to a project finance entity that is able to meet its financial commitments in a timely manner and its ability to do so is assessed to be robust against adverse changes in the economic cycle and business conditions.

Assessment

Overall, the Basel IV rules on corporate claims do what it says on the tin: the Standardised Approach looks more like the IRB Approaches and their respective capital outputs are more closely aligned.

The treatment of exposures to corporate SME's makes sense and the option to include them in qualifying retail portfolios, a somewhat confusing issue under the current rules, has been clarified.

The recalibration of the risk weights associated with external ratings also goes in the right direction although its impact is limited as it only affects corporates rated BBB- to BBB+.

A different, separate treatment for real estate exposures is also a positive development. As history has shown time and time again, commercial real estate can be a disproportionately large asset class for many banks and a risky, even dangerous one. This asset class will be reviewed in future articles.

Some of the new provisions, however, are less convincing:

First, there doesn't seem to be much point in creating new special lending categories like Object and Commodity finance, if it is to treat them exactly as before.

There is, in the IRB Approaches, a ready-made supervisory scale for these exposures that could have been imported.

Then there is the capitulation of the Basel Committee on the use of financial metrics, which were sacrificed on the altar of uniformity.

I think it is regrettable. Potentially hiding exposures to highly geared corporates behind a 100% risk weight is a major weakness of the Standardised Approach, and if banks are unable to "calculate" a company's turnover or leverage, maybe they shouldn't be in banking at all.

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