

## **RESPONSE TO FEEDBACK RECEIVED – CONSULTATION ON PROPOSALS FOR THE IMPLEMENTATION OF BASEL II IN SINGAPORE – PHASE 2**

### **1 Introduction**

1.1 In March 2006, MAS invited Singapore-incorporated banks to comment on draft rules and guidelines for computing minimum capital adequacy requirements for credit risk under Basel II.

1.2 We thank all respondents for their comments. MAS has considered carefully the feedback received, and where it agreed with the comments, will incorporate them into the revised draft guidance. Comments that are of wider interest, together with MAS' responses are set out below.

### **2 Recognised Parallel Run for A-IRBA**

2.1 One respondent asked if a Reporting Bank transitioning from F-IRBA to A-IRBA will be subject to another period of recognized parallel run.

#### MAS' Response

2.2 A Reporting Bank that has adopted F-IRBA and intends to adopt the A-IRBA will need to conduct a recognised parallel run of at least 1 year prior to its A-IRBA adoption date. This is to help ensure that the Reporting Bank has sufficiently robust systems and processes for estimating LGD and EAD.

### **3 Default System for Calculation of Credit RWA**

3.1 MAS proposed that Reporting Banks should have a process to calculate the credit risk-weighted exposure amount for any IRBA exposure using the SA(CR) within a reasonable timeframe if required by MAS to do so. One respondent had sought clarification on MAS' expectations of a "reasonable timeframe".

#### MAS' Response

3.2 In general, MAS would expect Reporting Banks to be able to calculate the credit risk-weighted exposure amount for any IRBA exposure based on MAS Notice 637 or the SA(CR) within a 3-month period.

### **4 Capital Requirement for Credit Protection Bought**

4.1 One respondent sought clarification if there would be any capital requirements for pre-settlement counterparty credit risk arising from eligible unfunded credit protection (e.g. credit derivatives) bought to hedge exposures in the banking book.

#### MAS' Response

4.2 Pre-settlement counterparty credit exposures arising from eligible unfunded credit protection used to hedge banking book exposures will not attract separate capital requirements. The exposure value for such credit protection should be taken as zero. This will be clarified in the revised exposure measurement guidelines.

### **5 Currency Mismatches**

5.1 One respondent sought clarification if eligible financial collateral subject to a currency mismatch will also attract a foreign exchange position risk charge.

## MAS' Response

5.2 The table below summarises the scenarios in which a currency mismatch and/or a foreign exchange risk position may occur. Specifically, where there is a currency mismatch between the eligible financial collateral and the underlying exposure, a Reporting Bank must adjust the value of the collateral by applying an appropriate haircut. The Reporting Bank must set aside a foreign exchange position risk charge only if the underlying exposure is denominated in a foreign currency. This will be clarified in the revised guidance.

	<b>Collateral denominated in domestic currency</b>	<b>Collateral denominated in foreign currency</b>
<b>Underlying exposure denominated in domestic currency</b>	<ul style="list-style-type: none"><li>• No currency mismatch</li><li>• No foreign exchange position risk charge</li></ul>	<ul style="list-style-type: none"><li>• Currency mismatch exists and appropriate haircuts to be applied to collateral amounts</li><li>• No foreign exchange position risk charge</li></ul>
<b>Underlying exposure denominated in foreign currency</b>	<ul style="list-style-type: none"><li>• Currency mismatch exists and appropriate haircuts to be applied to collateral amounts</li><li>• Foreign exchange position risk charge for underlying exposure</li></ul>	<ul style="list-style-type: none"><li>• No currency mismatch</li><li>• Foreign exchange position risk charge for underlying exposure</li></ul>

## **6 Regulatory Retail Asset Class under SA(CR)**

6.1 It was proposed in the consultation paper that the aggregate exposure to any one obligor within the regulatory retail asset class under the SA(CR) should not exceed 0.2% of the regulatory retail asset class or \$2 million, whichever is lower. One respondent proposed removing the 0.2% granularity threshold as it could be operationally challenging to meet this threshold, especially as more of the Reporting Banks' exposures transition to IRBA from SA(CR).

## MAS' Response

6.2 After considering the feedback received, MAS will remove the 0.2% granularity threshold. Reporting Banks should ensure that the aggregate exposure to any one obligor within the regulatory retail asset class does not exceed \$2 million. This change will be reflected in the revised draft rules.

## **7 Recognition of Residential Real Estate (“RRE”) and Commercial Real Estate (“CRE”) as Eligible Collateral for Past Due Loans under SA(CR)**

7.1 Some respondents sought clarification on the haircuts to be applied to eligible RRE and eligible CRE recognised as eligible collateral for past due loans under the SA(CR).

## MAS' Response

7.2 Where a Reporting Bank recognises eligible RRE and/or eligible CRE as eligible collateral for a past due loan under SA(CR), the portion of the loan secured by such collateral will be equal to the current market value of such collateral adjusted for the following haircuts:

- Eligible RRE – 10%
- Eligible CRE – 20%

The portion of the past due loan secured by such collateral will be risk weighted at 100%. This will be clarified in the revised draft rules.

## **8 Firm Size Adjustment for Exposures to Small Businesses under IRBA**

8.1 It was proposed in the consultation paper that Reporting Banks should have in place rigorous information gathering and timely updating processes to ensure that the annual sales figures used for the firm size adjustment are timely and relevant. In addition, the sales figures used must be audited and taken from

the most recent full-year financial statements, which should not be more than 18 months old.

8.2 One respondent proposed that audited financial statements should not be required for small businesses that are legally exempted from audit. In addition, the respondent suggested that audited financial statements of up to 24 months old be allowed. The respondent also highlighted that it would be operationally challenging for Reporting Banks to take positive actions to verify whether there has been any event after the date of the financial statements that would reasonably cause the \$100 million firm size threshold to be breached.

### MAS' Response

8.3 After considering the feedback received, MAS has decided not to require audited annual sales figures for the firm size adjustment in the case of Singapore-incorporated companies that are not required under the Companies Act to audit their financial statements. In such cases, Reporting Banks may rely on the unaudited management accounts of the companies concerned.

8.4 In all other cases, MAS expects Reporting Banks to endeavour to use audited sales figures that are not more than 18 months old. Audited figures that are not more than 24 months old will be admissible only under exceptional circumstances, e.g. change of auditors, corporate restructuring.

8.5 Reporting Banks will be expected not to use the firm-size adjustment if they become aware of any event after the date of the financial statements that would reasonably cause the \$100 million firm size threshold to be breached. This will be clarified in the revised draft rules.

## **9 Definition of Residential Mortgages under IRBA**

9.1 MAS proposed that exposures within the residential mortgage asset sub-class should meet, among other things, the following two criteria:

- (a) the loan is secured against a first-lien mortgage, or secured against a second lien mortgage if the Central Provident Fund of Singapore holds the first lien position: (i) of a completed residential property; (ii) of an uncompleted residential property in Singapore; or (iii) of an uncompleted residential property in a jurisdiction approved by the Authority on an exceptional basis; and
- (b) the loan is not past due by more than 90 days and is not rated as a classified loan under MAS Notice 612.

9.2 One respondent highlighted that criterion (a) above may preclude Reporting Banks from including short term loans, revolving term loans and overdraft facilities that are secured by residential mortgages in the residential mortgage asset sub-class as these exposures could be subject to lower priority liens. Another respondent proposed that criterion (b) be removed as there is no similar requirement for the other retail asset sub-classes.

#### MAS' Response

9.3 After considering the feedback received, MAS will remove the two criteria above from the IRBA definition of the residential mortgage asset sub-class. The revised draft guidance will be amended to reflect this.

9.4 The two criteria will remain under the SA(CR) to ensure that the 35% risk weight for exposures secured by residential property will apply only to exposures that meet the required prudential criteria.

## **10 Aggregation of Retail Exposures to Single Counterparty**

10.1 One respondent proposed that to maintain consistency between SA(CR) and IRBA, exposures within the residential mortgage asset sub-class should be excluded from the \$2 million retail exposure threshold used to determine if exposures to businesses can be included within the other retail exposures asset sub-class under the IRBA.

## MAS' Response

10.2 In line with the Basel Committee's guidance, regulatory retail exposures and exposures secured by residential property are defined as two separate asset classes under the SA(CR). The \$2 million threshold used to determine if exposures to businesses can be included within the regulatory retail asset class under the SA(CR) applies only to regulatory retail exposures, and excludes exposures secured by residential property.

10.3 In contrast, under IRBA, the retail asset class comprises the residential mortgage asset sub-class, the qualifying revolving retail asset sub-class and the other retail asset sub-class. The Basel Committee's guidance clearly requires a bank to aggregate all of its exposures within the entire retail asset class to a single counterparty to determine if the retail exposure threshold of \$2 million is met. MAS has adopted the Basel Committee's guidance, but has also provided flexibility for Reporting Banks to de-consolidate certain exposures if the counterparties have independent debt-servicing capabilities for those exposures.

## **11 Recognition of Structured Financial Products as Eligible Financial Collateral**

11.1 Some respondents sought clarification on the types of structured financial products that can be recognised as eligible financial collateral.

## MAS' Response

11.2 MAS will recognise the following structured financial products as eligible financial collateral:

- (a) a structured deposit issued by and on deposit with the Reporting Bank which is incurring the counterparty exposure, that meets the definition of a deposit under the Banking Act, subject to a supervisory haircut of 25%;

- (b) a structured note with an external credit assessment by an eligible external credit assessment institution (“ECAI”), subject to a supervisory haircut equal to the standard supervisory haircut that is applicable to a debt security with the same credit quality grade and same maturity as the structured note;
- (c) a structured note that does not have an external credit assessment by an eligible ECAI but is 100% principal-guaranteed by an eligible protection provider, subject to a supervisory haircut of 25%; and
- (d) a structured note that does not have an external credit assessment by an eligible ECAI but is issued by an issuer with a credit quality grade of at least 2 and where all the reference assets qualify as eligible financial collateral, subject to a supervisory haircut equal to the higher of (i) the standard supervisory haircut that is applicable to the reference asset with the highest haircut; and (ii) the standard supervisory haircut that is applicable to a debt security of the same maturity issued by the same issuer.

## **12 Recognition of Junior Liens on Eligible IRBA Collateral**

12.1 One respondent proposed that where the credit risk mitigation effects of a junior lien on eligible IRBA collateral are recognised, the recognised collateral value should be the fair market value of the collateral instead of the sum of the junior and senior liens held by the Reporting Bank.

### MAS' Response

12.2 MAS agrees with the comment and will revise the draft guidance so that the recognised collateral value will be equal to the fair market value of the collateral when a Reporting Bank recognizes the credit risk mitigation effects of a junior lien on eligible IRBA collateral.

## **13 Recognition of RRE as Collateral under F-IRBA**

13.1 MAS proposed that Reporting Banks that intend to recognise the credit risk mitigation effects of a junior lien on an eligible RRE must, among other things, hold all the senior liens.

13.2 One respondent highlighted that this requirement would preclude the recognition of eligible RRE where the bank holds a second lien and the first lien is held by the Central Provident Fund of Singapore (“CPF”).

### MAS’ Response

13.3 MAS will allow a Reporting Bank to recognise eligible RRE under F-IRBA where it holds the second lien, provided the first lien is held by CPF. To address the lower priority of claim on such collateral, Reporting Banks will be required to deduct the first lien (including principal and accrued interest) held by CPF from the value of the eligible RRE.

## **14 Recognition of Eligible Physical Collateral under F-IRBA**

14.1 Some respondents sought clarification on the types of eligible physical collateral that will be recognised under F-IRBA.

### MAS’ Response

14.2 MAS will recognise the following as eligible physical collateral under F-IRBA

- (a) all industrial properties in Singapore;
- (b) land in Singapore; and
- (c) land in another jurisdiction where the bank regulatory agency has recognised such land as eligible physical collateral.

The minimum LGD for exposures secured against such eligible physical collateral will be 0.40 (assuming a collateralisation level of 140% or more) and the minimum collateralisation level will be 30%. Reporting Banks should ensure that the industrial properties and/or land that they accept as eligible physical collateral fulfill the conditions in the revised draft guidance before recognizing them for the purposes of regulatory capital calculations. Reporting Banks should also have in place internal policies for defining and classifying different collateral types.

## **15 Timely Liquidation of Collateral**

15.1 MAS proposed that the liquidation process for eligible financial collateral should not exceed the minimum holding period assumed in calculating collateral haircuts, while that for eligible RRE/CRE should not take more than 1 year from the date of default. One respondent highlighted that the liquidation of collateral may not be the first course of action taken by a Reporting Bank upon default, and suggested that the stipulated timeframes be removed.

### MAS' Response

15.2 After considering the feedback received, MAS will not stipulate timelines for the liquidation of collateral. However, Reporting Banks should ensure that they have proper internal policies in place to facilitate the liquidation of collateral within a reasonable timeframe. MAS may, upon supervisory review, derecognise the credit risk mitigation effects of eligible collateral. In making such decisions, MAS would consider, among other things, the workout efforts of the Reporting Bank and prevailing market conditions for the type of eligible collateral concerned.

## **16 Off-Balance Sheet Exposures**

16.1 Some respondents sought clarification on the types of transactions that would fall under the category "Commitments with Certain Drawdown".

### MAS' Response

16.2 These would include forward purchase, forward deposits and partly paid shares and securities. This will be clarified in Annex 7B of the revised guidance.

MONETARY AUTHORITY OF SINGAPORE  
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