CONSULTATION PAPER

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IRB Approach Asset Class Definitions and Size Limits

Monetary Authority of Singapore

PREFACE

The Basel Committee on Banking Supervision's ("BCBS") document, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* ("Basel II"), requires banks adopting the internal ratings-based ("IRB") approach to categorise banking-book exposures into broad asset classes with different underlying risk characteristics according to definitions set out in the document.

This consultation paper sets out MAS' proposals on how Singapore-incorporated banks adopting the IRB approach should:

- Implement the retail asset and sub-asset class definitions; and
- Distinguish SME exposures from corporate exposures in general.

We invite comments from Singapore-incorporated banks and other interested parties. Please note that all submissions received may be made public unless confidentiality is specifically requested for all or part of the submission. Electronic submission is encouraged.

Please submit your comments in writing by 6 October 2004 to:

Prudential Policy Department
Monetary Authority of Singapore
10 Shenton Way, MAS Building
Singapore 079117
Fax: 62203973
Email: policy@mas.gov.sg

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SECTION 1 BACKGROUND

1.1 Under the IRB approach, banks must categorise banking-book exposures into broad classes of assets with different underlying risk characteristics according to definitions set out in Basel II. The classes of assets are (a) corporate, (b) sovereign, (c) bank, (d) retail, and (e) equity.

1.2 Classifying exposures to the sovereign, bank and equity asset classes is relatively straightforward compared to the classification of corporate and retail exposures. Within the retail asset class, three sub-classes are separately identified.[1] Within the corporate asset class, banks are permitted to distinguish separately exposures to small- and medium-sized entities ("SME"), as defined in Basel II.[2]

1.3 This consultation paper sets out MAS' proposal on how Singapore-incorporated banks adopting the IRB approach should implement the retail asset and sub-asset class definitions, and distinguish SME exposures from corporate exposures in general. For ease of reference, a flow chart illustrating the classification process is set out in Annex 1.

SECTION 2 RETAIL ASSET CLASS

RETAIL IN GENERAL

2.1 For an exposure to be categorised as a retail exposure under Basel II, it must meet two criteria – the borrower is an individual or a small business where the total exposure of the banking group to the small business borrower is less than €1 million; and the exposure is managed as part of a pool of similar exposures. In addition, Basel II gives national supervisors discretion to set:

- Exposure thresholds to distinguish between retail and corporate exposures; and
- A minimum number of exposures within a pool for exposures in that pool to be treated as retail.[3]

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1 BCBS, International Convergence of Capital Measurement and Capital Standards: A Revised Framework, June 2004, paragraph 215.

2 BCBS, ibid., paragraph 273.

3 BCBS, ibid., paragraphs 231 and 232.

2.2 While such additional prescriptions may better ensure granularity and homogeneity of retail pools, we do not propose to establish an overall exposure threshold to distinguish between retail and corporate asset classes nor set a minimum number of exposures per retail pool initially.[4] Instead, banks would have the flexibility to establish their own internal policies on ensuring the granularity and homogeneity of their retail pools, but we would expect such policies to be rigorous.

RESIDENTIAL MORTGAGE LOANS SUB-ASSET CLASS

2.3 Under Basel II, banks are required to categorise retail exposures in three sub-classes, that is, residential mortgage loans, qualifying revolving retail exposures and other retail. The definition of residential mortgage loans in Basel II requires that the loan be extended to an individual that is an owner-occupier of the property. Basel II gives national supervisors discretion to limit the maximum number of housing units per exposure.[5]

2.4 We propose to adopt the Basel II definition as it stands, that is, we propose that the following exposures may not be treated as a residential mortgage loan for the purposes of computing capital requirements:

- An exposure secured by a residential property that is extended to an individual who is not the owner-occupier of the property;
- An exposure to an individual that is secured by an uncompleted residential property; and
- An exposure to a corporate secured by a residential property.

We also propose to exercise the national discretion cited above and limit the maximum number of housing units per exposure to one.

2.5 Notwithstanding the foregoing, we recognise that a bank may sometimes structure an exposure to a corporate to replicate the risk profile of a direct exposure to an individual that is an owner-occupier.[6] Therefore, as a

[4] As a guide, MAS would initially consider the requirement under the Standardised Approach that each exposure in a regulatory retail portfolio not exceed 0.2% of the portfolio as a reasonable level of granularity.

[5] BCBS, op. cit., paragraph 231.

[6] For example, a loan to a company whose sole business is to hold a property which the director-shareholders of the company occupy and whose obligations are guaranteed without limitation by the same director-shareholders, may be treated as a

concession, we propose that a bank may treat as a residential mortgage loan, an exposure secured by residential property that is not extended to an individual who is the owner-occupier of the property, provided:

- The bank can demonstrate that it has robust processes to ascertain that the facility structure does replicate the risk profile of an exposure to an individual who is an owner-occupier of the residential property; and

- The bank is able to identify and manage the legal risks that arise in such structures.

2.6 Loans secured by residential property that do not meet the requirements for classification as residential mortgage loans are to be categorised as other retail or corporate exposures, as appropriate.

QUALIFYING REVOLVING RETAIL EXPOSURES SUB-ASSET CLASS

2.7 Basel II sets out criteria to define the qualifying revolving retail exposures sub-asset class.[7] We propose to implement the criteria as defined,[8] except that the maximum exposure to a single individual in the sub-portfolio must not exceed S$100,000. We are of the view that a limit of S$100,000 will be more relevant in our local context than the equivalent of €100,000.

SMALL BUSINESS EXPOSURES TREATED AS RETAIL

2.8 Under Basel II, loans extended to small businesses and managed as retail exposures are eligible for retail treatment, provided the total exposure of the banking group to a small business borrower (on a consolidated basis[9] where applicable) is less than €1 million.

2.9 We propose to allow small business exposures managed as retail exposures to be eligible for IRB retail treatment. However, the equivalent of

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residential mortgage loan, subject to the associated legal risk being well-managed. However, if the company were to have other business activities in addition to holding the property, such an exposure cannot be treated as a residential mortgage loan.

7 BCBS, op. cit., paragraph 234.

8 As qualifying revolving retail exposures must be to individuals, revolving exposures to small businesses or corporates must be categorised as other retail or corporate exposures, as appropriate.

9 The proposed basis of consolidation is set out in Paragraph 4.1.

€1 million as the threshold for the exposure to be considered retail seems high for our local context and we propose to set the threshold at S$1 million instead.

2.10 In general, we also expect that when a small business exposure crosses the S$1 million threshold, the bank must re-classify the exposure as a corporate exposure. However, we propose to be flexible if the need for re-classification arises solely from short-term exchange rate fluctuations, e.g., for non-Singapore Dollar-denominated assets. In such cases, we would expect banks to establish appropriate policies and processes to determine when the threshold is exceeded in a more permanent way, e.g., through the extension of increased credit or a major currency revaluation, and to re-classify the exposures if necessary.

2.11 Banks are reminded that small business exposures that are less than the S$1 million are not automatically eligible for IRB retail treatment. Banks must still demonstrate that its small business exposure pools meet all the requirements regarding the management of pooled exposures for the derivation of robust IRB estimates.

SECTION 3 SME EXPOSURES

3.1 Under the IRB approach for corporate credits, banks will be permitted to distinguish separately exposures to SME borrowers (defined as corporate exposures where the reported sales for the consolidated group of which the firm is a part is less than €50 million) from those to large firms.

3.2 In the firm-size adjustment to the correlation factor in the capital requirement function,[10] we propose that the variable S be expressed as the total annual sales in millions of Singapore Dollars where S is between S$5 million and S$50 million. Reported sales of less than S$5 million will be treated as if they were equivalent to S$5 million for the purposes of the firm-size adjustment for SME borrowers.

3.3 We expect banks to implement rigorous information gathering and timely updating processes to ensure that the consolidated sales figure used is timely and relevant. At the minimum:

[10] BCBS, op.cit., paragraph 273.

- The sales figure used must be audited and taken from the most recent full-year financial statement. The financial statement must be for a period ending not more than 18 months before the time when the firm size adjustment is computed. For example, the sales figure for the 12 months ending 31 Dec 02 may not be used for computing the firm size adjustment after 30 Jun 04; and

- The S$50 million consolidated sales threshold is to be adhered to strictly.

If a bank is unable to meet these requirements, or is aware of events after the date of the financial statements that would cause the threshold to be breached, it may not distinguish the affected exposures are as exposures to SME borrowers.

3.4 We propose not to exercise the national discretion to allow total assets to be substituted for annual sales in the SME firm-size adjustment.

3.5 We seek banks' views on the appropriateness of the firm-size adjustment in markets in which they have significant operations, that is, whether the sales threshold is appropriate, whether the resulting capital requirements are consistent with banks' default experience and whether the firm-size adjustment is cost-effective to implement in view of the data requirements.

SECTION 4 ANCILLARY ISSUES

BASIS OF CONSOLIDATION

4.1 We propose that the basis of consolidation for small business exposures under S$1 million that are treated as retail exposures will be the definition of a borrower group used by the bank for its risk management purposes, with the proviso that exposures to the sole proprietors or partners in any of the entities in the group are to be included in the consolidation.

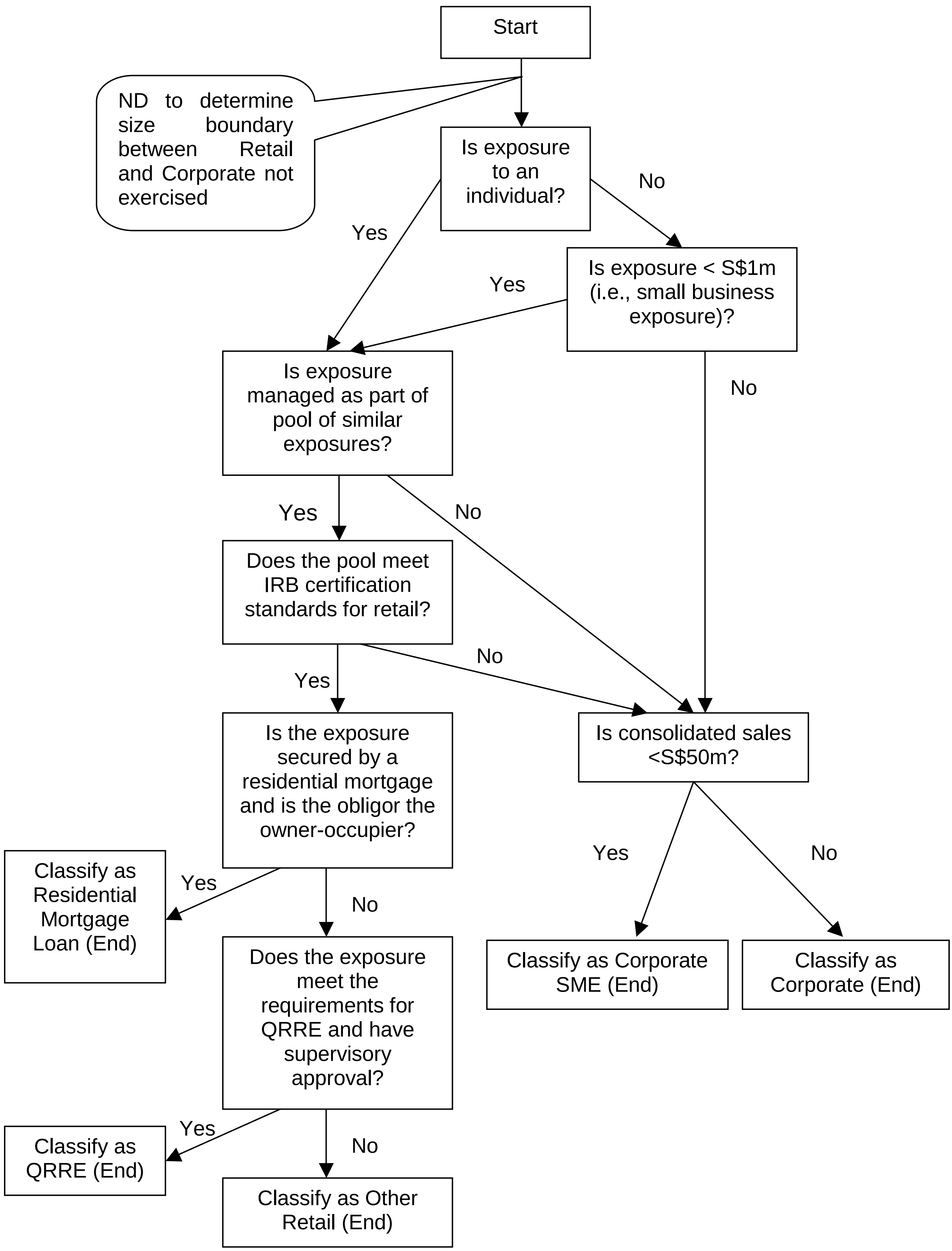
4.2 We propose that the basis of consolidation for SME borrowers will be that pursuant to Section 201 of the Companies Act.

CURRENCY TRANSLATION

4.3 In the foregoing proposals, we have consistently proposed to prescribe the various Euro-denominated size limits in terms of Singapore

Dollars. We believe that this will lower the compliance burden on banks. However, we recognise that banks with cross-border exposures or overseas operations will need to translate foreign currency amounts into Singapore Dollars to check compliance with the small business and QRRE size limits and to compute the SME firm-size adjustment. We are still considering what would be the appropriate basis and frequency for translating such exposures. While we intend to provide banks some flexibility in this matter, we also seek to maintain cross-border comparability and consistency across institutions. We invite banks' comments on the basis and frequency they consider appropriate.

Annex 1: Asset Classification Process



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