

Implementation of the Standardised Approach for Credit Risk: Key Revisions under Basel III and the Impact on Banks

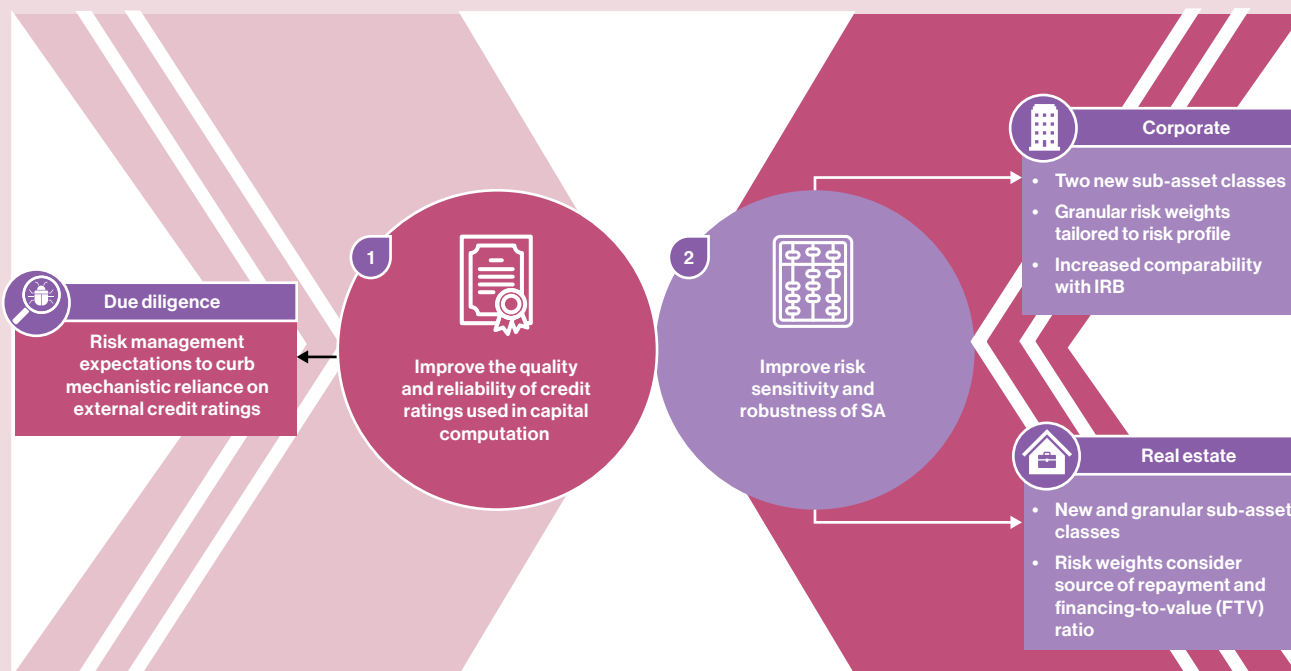
In 2017, the Basel Committee on Banking Supervision (BCBS) finalised key components of the revised capital framework for banks i.e. Basel III. The revisions in the framework were aimed at addressing the weaknesses identified from the 2008 global financial crisis. A key component of the revision is the computation of the risk-weighted assets (RWAs) for credit, market and operational risks to better reflect the inherent risk of these exposures.

BNM is committed to aligning the domestic capital framework with Basel III. This aims to enhance the resilience of our banking system against any potential shocks while ensuring that banks continue to support Malaysia’s financing needs. In line with this commitment, BNM issued a revised capital framework for credit risk under the standardised approach (Standardised Approach for Credit Risk (SA)) in November 2024. The SA strengthens the capital buffers that banks hold against shocks in two ways (Diagram 1):

- i. Improve the quality and reliability of credit ratings used in capital computation by requiring banks to independently conduct due diligence of borrowers, instead of relying solely on their external credit ratings.
- ii. Improve the risk sensitivity and robustness of the standardised approach in computing capital.

These enhancements would also bring the SA more in alignment with the Internal Ratings-based approach for Credit Risk (IRB).

Diagram 1: Summary of the SA Revisions



Source: Bank Negara Malaysia

Due diligence requirement

Under Basel II, banks can use external credit ratings by rating agencies to determine the risk weights of corporate credit risk exposures. The due diligence requirement introduced in Basel III ensures that banks have a thorough understanding of the underlying risks of their exposures and do not mechanistically rely on external credit ratings. If banks observe the external credit ratings do not fully account for the underlying risks, they must revise the credit ratings and increase the regulatory risk weights for those exposures.

In Malaysia, under BNM's credit risk management expectations, banks are already required to perform credit risk assessments¹ on the borrower, where they must consider all relevant factors including macroeconomic, transaction, counterparty and country-risks when deriving a credit rating. In addition, when using external credit ratings, banks must demonstrate that they have sound understanding of the assessment methodology adopted by the rating agency. Therefore, the due diligence requirements under Basel III will better align credit ratings used for internal risk management and capital computation purposes. Banks operating in Malaysia are therefore well-placed to adopt the due diligence requirements under Basel III. The sophistication of the due diligence practices will depend on the size and complexity of the bank's financing activities.

Recalibration of risk weights for key asset classes

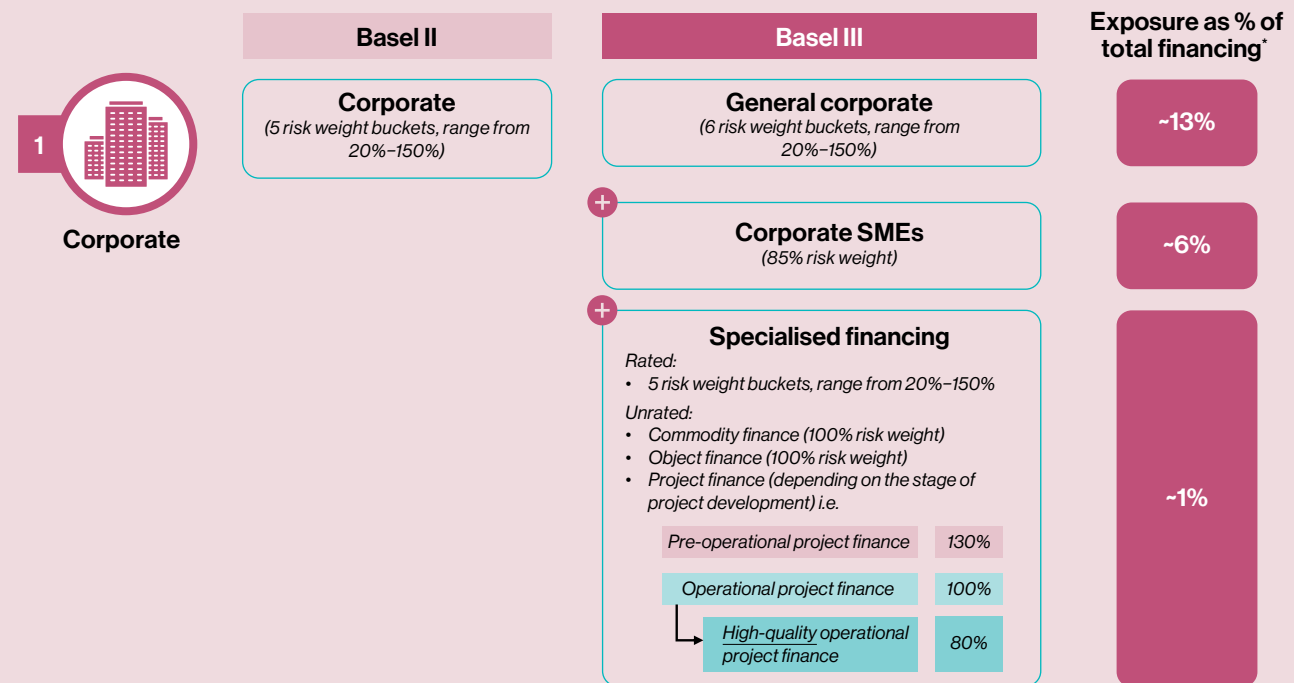
Under Basel II, certain asset classes are assigned flat risk weights or limited categories of risk weights. As a result, the risk weights prescribed under Basel II are not sufficiently granular to distinguish between different risk profiles of exposures and are less sensitive to changes in risk profiles compared to that observed under the IRB approach.

In line with Basel III, a number of new asset classes with more granular risk weights were introduced under the SA to improve the sensitivity of the risk weights and enhance comparability with IRB. These recalibrations mainly affected risk weights for financing to: (i) corporate exposures, and (ii) real estate exposures.

i. Corporate exposures

Under Basel III, corporate exposures are broken down into three categories i.e. general corporate, corporate SMEs and specialised financing (Diagram 2) to better reflect the underlying characteristic and risk profile of the various types of corporate exposures.

Diagram 2: Corporate Exposures under Basel II and Basel III



+ New sub-asset classes introduced under Basel III

* Total financing provided by banks, based on banks' submission to the Quantitative Impact Study for the position as at 31 December 2023.

Source: Bank Negara Malaysia

¹ Requirement stipulated in Credit Risk policy document.

In Malaysia, the predominant corporate exposures are in general corporate and corporate SMEs. Based on the Quantitative Impact Study (QIS)² conducted during the industry consultation process, 31% of the total corporate exposure will qualify as corporate SMEs exposure and attract a lower risk weight of 85%. Under Basel II, these SME exposures are normally unrated and would attract 100% risk weight. Specialised financing exposures are currently small, accounting for less than 1% of total financing, with the larger part being in project finance. Under Basel III, risk weights for project finance are broken down into three risk weight buckets which differentiate the risk of the project based on the project life-cycle and recognise certain features of the project which render it high-quality.

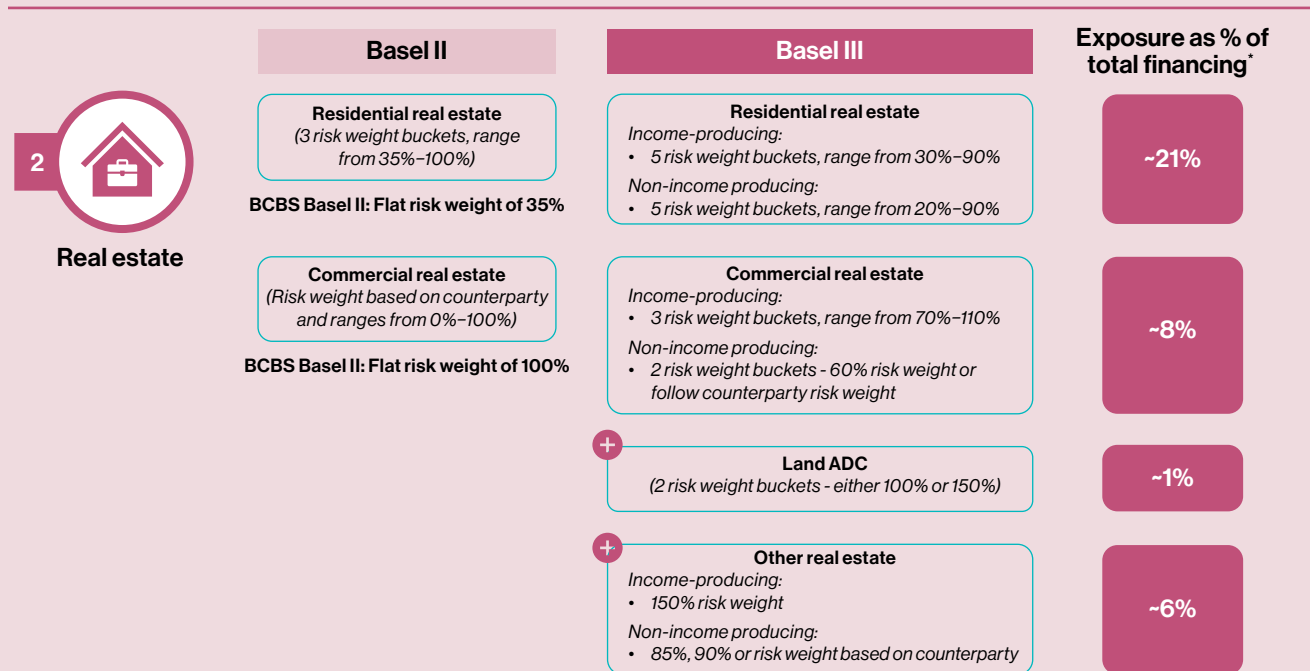
ii. Real estate exposures

Basel III introduces a more granular asset classification for real estate exposures namely residential real estate (RRE), commercial real estate (CRE), land acquisition, development, and construction (land ADC) and other real estate (Diagram 3).

RRE and CRE are further categorised into income-producing and non-income producing exposures. This is based on how the financing is expected to be repaid i.e. whether repayment is dependent on cash flows generated by the real estate collateral (income-producing) or based on the borrower’s capacity to service the financing (non-income producing). In addition, the risk weights for these exposures are calibrated to be more risk-sensitive to their level of collateralisation i.e. financing-to-value (FTV).

Land ADC exposures attract a higher risk weight due to the construction performance risk as the source of repayment depends on the cash flows generated by the property under construction.

Diagram 3: Real Estate Exposures under Basel II and Basel III



+ New sub-asset classes introduced under Basel III

* Total financing provided by banks, based on banks’ submission to the Quantitative Impact Study for the position as at 31 December 2023.

Source: Bank Negara Malaysia

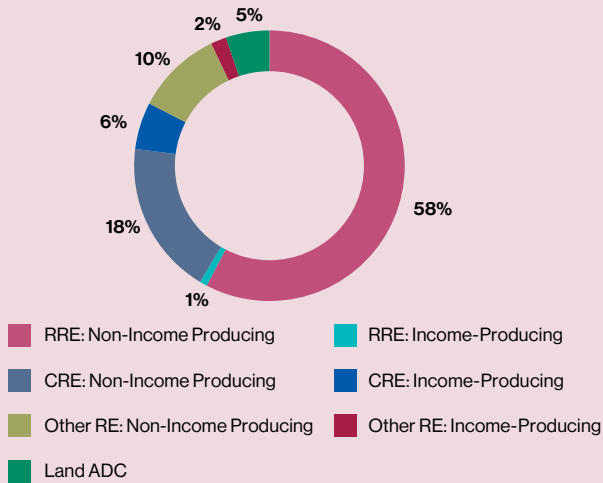
² The QIS was issued in 2023, alongside the release of the exposure draft on the SA.

Based on QIS, around 60% of the real estate exposures of banks in Malaysia under SA are RRE. Of this, more than half of the exposures will qualify for lower risk weights based on the more granular FTV buckets (Diagram 4).

Diagram 4: Real Estate Exposures for SA Banks

Non-income producing RRE makes up over half of the real estate exposures for SA banks

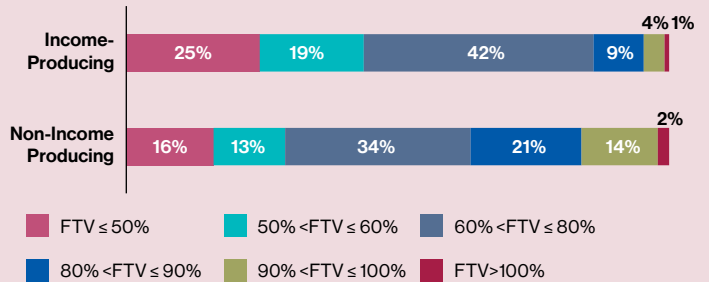
Breakdown of real estate exposures (%)*



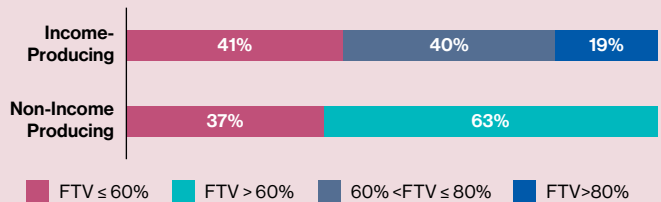
Over half of the RRE exposures have an FTV of 80% and below

Breakdown of performing exposures by FTV (%)*

(1) Residential Real Estate



(2) Commercial Real Estate



* Based on banks' submission to the Quantitative Impact Study for the position as at 31 December 2023.

Source: Bank Negara Malaysia

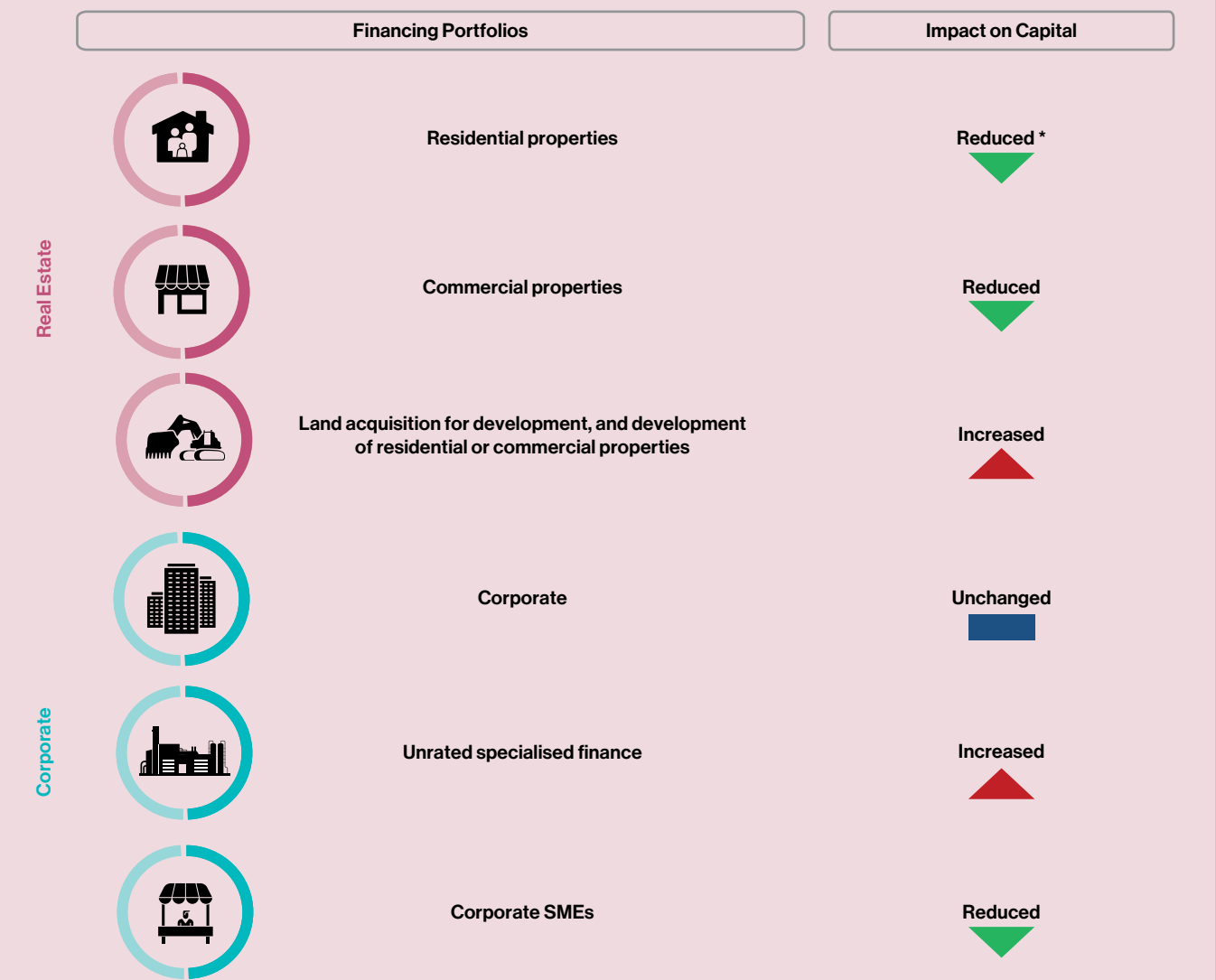
Basel III also requires banks to compute the FTV ratio using the value of the property at the point of financing origination. This approach is intended to mitigate the impact of sharp price fluctuations during property booms or busts that could lead to excessive cyclical in risk weights, and ultimately, capital and lending activity.

Expected impact on banks' capital

The results from the QIS carried out by BNM based on outstanding exposures as at 31 December 2023, indicate that changes to the SA are expected to have a fairly neutral capital impact on banks. At the industry level, the total capital ratio of banks adopting the SA will improve by 25 basis points. However, the impact to individual banks varies, depending on their financing portfolios and risk profiles (Diagram 5).

The SA will come into effect on 1 July 2026.

Diagram 5: Financing Portfolios



Note:
* Assuming growth in property values remains stable.

Based on banks' submission to the Quantitative Impact Study for the position as at 31 December 2023.

Source: Bank Negara Malaysia