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Standard & Poor's Response To The Basel Committee's Proposals On Bank Capital And Liquidity

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*(**Editor's Note:** This article is part of a series of comments by Standard & Poor's Ratings Services in response to the Basel Committee on Banking Supervision's proposals on bank capital and liquidity released for comment in December 2009. This article supplements our views outlined originally in the report: "Basel 3 For Global Banks: Third Time's The Charm," published on March 4, 2010. The Basel Committee's comment period ends on April 16, and it is planning to issue final rules by the end of 2010 with implementation scheduled for 2012.)*

The proposals on bank capital and liquidity by the Basel Committee on Banking Supervision, contained in two consultative documents released in December 2009: "Strengthening the resilience of the banking sector" and "International framework for liquidity risk measurements, standards and monitoring" are very significant.

If the final form of the proposals, known as Basel III, is reasonably similar to the consultative version, we believe that the reforms are likely to extend the scope of the balance sheet strengthening measures already initiated by many banks, and potentially trigger fundamental changes in business models and product pricing. In this sense, they could in our opinion mark one of the most significant developments in banking regulation since the original Basel Accord was introduced in 1988.

As a preliminary matter, we would suggest that the recent financial crisis has called into question several of the Basel II framework's implicit underlying assumptions. We also suggest that the whole Basel capital framework is excessively complicated and, as a consequence, difficult to interpret by market constituents. In general, we consider that the proposals address some of the shortcomings in the current regulatory approach that were highlighted by the recent downturn.

We see the essence of the capital proposals as being generally consistent with our in-house analytical tools, such as our risk-adjusted capital framework (RACF). We believe that the implementation of a more consistent and stringent definition of Tier 1 capital would help facilitate the work of bank analysts. We developed the RACF and our own definitions of bank capital because we consider that the value of existing regulatory ratios is undermined by what we view as methodological weaknesses and by inconsistencies in their application by national regulators. While the proposals have the potential to address some of these issues, we believe that the comparability of regulatory ratios would likely still be blurred by differences between banks' internal rating models and by the availability of various options to assess identical risks.

The liquidity proposals represent the first attempt by international regulators to introduce harmonized minimum standards. The introduction of such standards could serve to significantly strengthen banks' liquidity positions and enhance the supervisory review process. More extensive and consistent disclosure standards regarding composition of regulatory capital, liquidity metrics and adjusted assets, we believe will also provide additional information to analysts and market participants more generally.

The spirit of the Basel III proposals is in our view broadly consistent with the expectations factored into our current bank ratings, some of which are partly predicated on capitalization and funding profiles being strengthened ahead of governments and central banks withdrawing support for the banking system. We expect to revisit this view as the

proposals move closer to their final form.

Some of our main observations on the proposals are:

- Depending on the assumptions used to compute the short-term liquidity metric and the structural funding metric, the introduction of these minimum standards may have unintended consequences. In our view, a restrictive approach to the definition of liquid assets and requirements for funding certain types of assets with long-term funds could cause displacements in markets for high-quality liquid securities by distorting supply/demand fundamentals. We believe that a certain level of maturity mismatches between assets and liabilities is inherent to the role that the banking system plays in the economy.
- In our view, the timetable for implementing the Liquidity Framework appears long, given that the final standard would only become effective in 2013. We believe that a long transition period could create the risk of delays, unless there are interim milestones.
- The grandfathering of hybrid capital instruments may create a lack of comparability in regulatory capital ratios for an extended period of time;
- The proposal to deduct all minority interests in consolidated subsidiaries from common equity appears in our view to be a relatively simplistic response to legitimate concerns over the fungibility of capital, and any similar adjustment to risk-weighted assets could make such measure less relevant to third party users, including credit analysts;
- The allocation of "going-concern" capital to some nonbanking businesses, such as insurance, we believe would be consistent with our current approach, under which capital cannot be available at the same time to the bank and to the insurer.
- The revision in regulatory adjustments could in our opinion create some pro-cyclicality;
- The leverage ratio, although very rough, could complement risk-adjusted capital metrics. We believe it could play a role in strengthening the pillar 2 of the regulatory framework (supervisory review). However, assigning too much importance to this measure could in our view provide incentives to banks to make riskier investment decisions.
- The calibration of capital charges for counterparty risk appears dimensioned to weather far bigger stress than that experienced by banks in the past two years. In some instances, it could discourage the use of internal models; and
- The current proposals regarding countercyclical measures still do not appear fully developed and calibration might remain a difficult exercise until the pro-cyclicality of Basel II IRB systems is better assessed.

Merit In Liquidity Standards, But Assumptions Could Distort Lending

We believe that the proposal to introduce a short-term liquidity metric as a minimum standard for internationally active banks could over time enhance their creditworthiness. However, we are concerned that some of the assumptions used may severely hamper the inter-bank lending market and cause displacements in markets for high-quality liquid securities. The proposed definition of high quality liquid assets appears in our view to be significantly more restrictive than the standards central banks typically maintain for collateral eligibility under the liquidity facilities that serve as a key backstop to the banking system. In light of central banks' crucial role in ensuring system liquidity in times of stress, collateral eligibility indicates than an asset, after appropriate haircuts, is liquid. In our analysis we would also typically look at the quality and diversity of "liquid assets" in order to assess event risk that could jeopardize the "liquidity" of a given asset.

The exclusion of banks' and investment and insurance companies' debt from qualification as "high quality liquid assets", combined with the proposed asymmetric treatment of undrawn credit and liquidity facilities between financial institutions, could in our view severely hamper the interbank lending market and also lead to other capital market dislocations, as banks could be forced to reallocate their liquidity buffers.

We believe the structural funding metric (net stable funding ratio) could be very useful in our analysis of a bank. We question though the appropriateness of the tentative calibration. We believe that some level of mismatching between assets and liabilities is inherent in banking and necessary for banks to fulfill their role in the economy. If implemented as proposed, one potential unintended effect could be to encourage banks to shift towards short-term lending.

Stricter Definitions Of Hybrid Capital Instruments Generally Accords With Standard & Poor's Recent Criteria Refinements

In our view, the Basel III proposals are likely to strengthen and simplify the capital structure of banks. Recent experience has shown us that the co-existence of multiple classes of regulatory capital instruments has sometimes had unintended consequences in terms of the flexibility to defer or suspend coupons and the predictability of banks' behavior. Furthermore, some regulatory capital instruments such as nondeferrable Tier 2 issues and Tier 3 issues had minimal equity content in our view, and therefore we have not typically included them in our capital measures. We understand that the Basel committee intends that Tier 1 capital should enable each bank to remain a going concern, with Tier 2 capital re-categorized as a "gone concern" reserve to protect depositors in the event of insolvency. We expect to assess the credit implications of the extension risk that may be created by the proposed introduction of a lock-in clause in respect of Tier 2 capital in the future.

The introduction of much stricter criteria for the inclusion of hybrid instruments into Tier 1 capital generally accords with our recent criteria refinement, under which our capital metrics would give only minimal equity content to certain types of hybrids that we do not view as providing sufficient flexibility to defer or suspend coupons. The loss absorption capacity provided by principal write-down or conversion features is not a condition for equity content under our criteria. (See "Assumptions: Clarification Of The Equity Content Categories Used For Bank And Insurance Hybrid Instruments With Restricted Ability To Defer Payments," published Feb. 9, 2010.)

The proposals state that "innovative" capital instruments with an incentive to redeem through features like step-up clauses (currently limited to 15% of the Tier 1 capital base) will be phased out. We currently assign different levels of equity credit to some hybrids with step-up features (or equivalent features) depending on their individual features. As stated in our criteria, step-ups (and similar provisions) question the permanence of issues that incorporate them, and so undermine the equity content of a hybrid capital security. Such hybrids are in our view therefore a weaker form of capital than other hybrids included in our measures of capital, such as similar instruments without step-ups.

Contingent capital may address some of the demonstrated deficiencies of traditional hybrid structures. One of the difficulties in practice in our view, however, is how to assess whether contingent capital securities would convert into capital (through conversion or a form of write-down) early enough to help a bank experiencing capital pressures. Some triggers may be lagging indicators of the bank's health.

As stated in our published criteria, we may take the view to deny equity credit to hybrid instruments even if regulators allow for grandfathering, based on our view of the fundamental characteristics of the instruments. We

interpret the grandfathering proposals as being a method for regulators to enable banks to transition to a more conservative regulatory environment without requiring large capital-raising in the short- to medium-term. In our view, grandfathering can create inconsistencies and a lack of comparability in capital ratios that could remain for an extended period. Grandfathering could also result in hybrid instruments that have been demonstrated to be ineffective as a form of capital still being included in regulatory capital measures.

Regulatory Adjustments To Capital May Not Be Effective For Complex Financial Conglomerates

We believe our capital measures already reflect most, but not all, of the capital deductions proposed either in the calculation of the capital amount or in one-for-one capital charges in our risk-weighted assets. A notable difference in our approach we believe relates to the share of common equity attributable to minority interests in consolidated subsidiaries, which we would exclude from common equity only if the non-fully-owned consolidated subsidiary were a nonfinancial entity such as a property or industrial company or a special purpose vehicle. We regard the proposal to systematically exclude from common equity the share attributable to minority interests as a relatively simplistic response to legitimate concerns regarding the fungibility of capital. Some participants in the banking industry have suggested applying a symmetrical approach of deducting the share of capital and of risk-weighted assets attributable to minority interests. If such an approach were retained, we believe that it could result in a material disconnection between the scope covered by the definition of regulatory risk-weighted assets and the economic reality of banking groups. Such a gap we expect would be likely to make ratios based on regulatory risk-weighted assets less relevant to analysts. Overall, we believe that the exclusion of minority interests from Tier 1 capital is introducing multiple layers of complexity in the computation of regulatory capital ratios. Under Standard & Poor's criteria, both capital amount and risk-weighted assets reflect our view of the full scope of the banking operations of groups, including the share attributable to minority interests.

The proposal to discontinue regulatory adjustments for unrealized gains and losses on securities or properties we believe would likely exacerbate pro-cyclicality, which is already perceived as an issue under the Basel II regime. The deduction of treasury stock is similar to the approach followed by Standard & Poor's. However, in our view requirements to look through holdings of index securities to deduct exposures to a bank's own shares, or to deduct gross long positions net of short positions only if the short positions do not involve counterparty risk, goes beyond what we believe is needed to avoid the double counting of a bank's own capital. The requirements in our view may have unintended consequences on the ability of banks to perform certain market making functions in the equity markets.

The proposal that the regulatory adjustments should be deducted from common equity rather than a broader capital measure appears to address one of the weaknesses of the current regime, where capital needs of certain activities, particularly nonbanking businesses such as insurance, were partly or entirely covered by subordinated debt which did not absorb losses on a going-concern basis. Given the complexity of capital requirements for financial conglomerates, in our view there is a risk that this more demanding rule will not be implemented in a consistent manner in all jurisdictions.

Leverage Ratio, Although Crude, Could Be A Pillar 2 Complement To Risk Adjusted Ratios

Standard & Poor's believes that a leverage ratio would supplement the regulatory capital ratio by discouraging excessive build-ups of positions that are assessed as risk free (or nearly so) under the pillar 1 capital ratio. We believe it could play a role in strengthening the pillar 2 of the regulatory framework (supervisory review) and helping to identify outliers. However, such a very rough measure would, in our view, require full transparency to be valuably interpreted by market participants. Furthermore, assigning too much importance to this measure could provide incentives to banks to make riskier investment decisions. They could be pushed to move away from low-risk, low-yielding businesses to concentrate on higher-risk, higher-return assets.

The introduction of a measure of adjusted assets that minimizes inconsistencies between accounting standards in our view would help to facilitate cross-regional comparisons, even beyond its particular use in a leverage ratio. However, an excessively wide definition of adjusted "gross" assets we believe could make such information less relevant and potentially misleading to analysts. For that purpose, we view favorably the alternative approach suggested for derivatives, which would recognize regulatory netting as per the current capital framework. We also concur with the alternative approach suggested for other off-balance sheet items, an approach which applies the standardized conversion factors from the current capital framework. We note, however, that standardized credit conversion factors for several items, including committed and uncommitted short-term credit lines, understated the underlying risk based on the experience of the past two years. On the other hand the proposed approach for cash and cash-like instruments (inclusion without exception), for securitization (use of accounting data and no recognition of synthetic securitization), for repurchase transactions, and for securities finance transactions (no recognition of netting) is an appropriate recognition of the underlying economic realities.

In our view the effectiveness of the proposal will depend heavily on the final definition of the leverage ratio. If poorly calibrated, we believe it could lead to outcomes that might be seen as undesirable from a broader perspective, such as for example a reduction in liquidity in the repo market as banks reduce their portfolios to manage the leverage ratio calculations. Standard & Poor's believes that in order to enhance the stability of the banking sector, risk-adjusted capital ratios should play a more important role than simple leverage ratios. The design of any new leverage ratio we believe should aim to address the concern that it does not become a more meaningful constraint for bank's management than the risk-based capital ratios, nor that it becomes a critical constraint in periods of stress. The calibration of the ratio in our view should also take into account the fact that it is currently untested.

If banks disclose "adjusted assets", we believe that a number of asset-based ratios that are not focused on assessment of capital strength (including profitability, asset quality or liquidity ratios) would likely become more comparable across regions when using such "adjusted asset" measures instead of reported balance sheet assets, notably when accounting standards differ. Such measures may therefore provide additional value to market participants and commentators on credit risk, including Standard & Poor's.

Charges For Counterparty Risk Could Be Too Punitive

Although we understand the underlying concept of the VaR on Credit Valuation Adjustments, particularly with the one-year horizon, we note that regulatory capital charges under the proposed calibration, including the regulatory scaling factor of at least three, could be far higher than the counterparty risk losses endured by banks during the

recent crisis.

Basel's recognition that default correlations among financial institutions tend to be higher than among non-financial companies resonates with Standard & Poor's internal assessments made in early 2009 and embedded, for instance, in our RACF.

We understand the proposal to lengthen the margin period at risk up to 20 days on OTC derivatives for banks using expected positive exposure (EPE) under the conditions defined in the proposals (exotic trades, illiquid collateral, etc). However, we note that the combination of this proposal with the stressed EPE could translate into higher capital charges for banks using internal models (EPE) than for banks using less sophisticated approaches to measuring counterparty risk exposures. We believe that this potential inconsistency may have unintended consequences as banks would be penalized for having sophisticated risk-management metrics.

Countercyclical Measures

The current proposals regarding countercyclical measures still do not appear fully developed. We believe that the creditworthiness of the banking sector would benefit from preventive intervention by national supervisors to avoid banks' capital trending too close to regulatory minimums.

We support the IASB's initiative to review the accounting model for impairment of existing loan portfolios as is mentioned in the Basel Committee's consultative document, and are reviewing the specific proposal to adopt an expected loss approach. The principle to put in place countercyclical measures in the form of regulatory requirements should improve the creditworthiness of the banking industry. The apparent procyclicality of the Basel II ratio has been one of the factors behind our decision to develop our own risk adjusted capital measure. We also note that procyclical behaviors in provisioning and economic leverage at the top of the cycle appeared to have contributed to an erosion of banking system resilience to the recent crisis. However, in our view, the current proposals are still imprecise and calibration might remain a difficult exercise until the procyclicality of Basel II IRB systems is better understood and until provisioning standards provide stronger buffers against cyclical pressures.

Related Research

Basel III Proposal To Increase Capital Requirements For Counterparty Credit Risk May Significantly Affect Derivatives Trading, April 15, 2010

Basel III Proposals Could Strengthen Banks' Liquidity, But May Have Unintended Consequences, April 15, 2010

The Basel III Leverage Ratio Is A Raw Measure, But Could Supplement Risk-Based Capital Metrics, April 15, 2010

Basel 3 For Global Banks: Third Time's The Charm?, March 4, 2010

Basel II And Standard & Poor's Risk-Adjusted Capital Framework: Links To Our Research Since 2001, Dec. 14, 2009

S&P Ratio Highlights Disparate Capital Strength Among The World's Biggest Banks, Nov. 30, 2009

Methodology And Assumptions: Risk-Adjusted Capital Framework For Financial Institutions, April 21, 2009

FI Criteria: Bank Rating Analysis Methodology Profile, March 18, 2004

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