

27 March 2015

Basel Committee on Banking Supervision
c/o Bank for International Settlements
CH-4002
Basel
Switzerland

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**MOODY'S INVESTORS SERVICE COMMENT ON CONSULTATIVE DOCUMENTS:
REVISIONS TO THE STANDARDISED APPROACH TO CREDIT RISK AND CAPITAL
FLOORS: THE DESIGN OF A FRAMEWORK BASED ON STANDARDISED APPROACHES**

Moody's Investors Service ("MIS") welcomes the opportunity to comment on the Consultative Documents: *Revisions to the Standardised Approach for Credit Risk* and *Capital Floors: the design of a framework based on Standardised Approaches*. Our comments focus on:

1. The benefit of using a wider set of metrics;
2. Our comment on the metrics identified;
3. General observations (with a focus on consistency); and
4. The impact on the capital floor.

1. Broad coverage of credit risk

MIS supports a simplification to the Standardised Approach to Credit Risk ("Standardised Approach"). However, simplification of the approach should not mean that the understanding of the risk to be measured should suffer because of the reduction in the number (or quality) of prescribed metrics that determine risk-weighted assets "RWA".

Firstly, the proposal to reduce mechanistic reliance on credit ratings in the Standardised Approach is supported. In a recent Joint Forum Report, firms and supervisors noted the move away from the mechanistic reliance on external credit assessments but many were moving towards a paradigm that

encompassed a risk management framework that considered multiple factors, including external credit ratings and ratings derived from internal models with external ratings acting as a constructive reference point.¹ It would seem that this is the right balance and the appropriate use of external ratings. Granting its member regulators and banks the flexibility to use various measures to calculate the banks' RWAs, the BCBS would allow for a better understanding and measurement of the risks associated with the exposure.

2. Proposed Risk Drivers (Capital Adequacy and Asset Quality) for Capital Charges on Exposures on Banks

MIS recognises the relevance of bank capital adequacy and asset quality in predicting bank failures. These new metrics are likely to lead to banks requiring to hold additional capital. However, measuring the risk profile of a bank's exposures is multi-faceted (we have noted the ongoing discussion on the inclusion of leverage as a factor) and requires additional key metrics. For example:

- a.) MIS considers capital and profitability, particularly stable and reliable earnings, as mitigants to asset quality concerns. To only consider capital as a mitigant can be misleading as banks that have strong and stable earnings and good access to capital markets can, all things being equal, manage to a somewhat lower CET1 ratio than peers with weaker organic capital generation and or more limited access to the equity markets.
- b.) Similarly, consideration of a bank's funding mix and profile and its liquidity position are absent from the proposals. As has been shown in the crisis, banks exposed to short–medium term liquidity stresses can fail well before capital becomes an issue. While potentially less important as drivers than asset quality and its mitigants (capital and profitability), we believe the BCBS should consider the inclusion of liquidity and funding metrics in the proposed framework.
- c.) In our revised bank rating methodology,² macro profile scores “condition” the rating of financial factors e.g. a bank with a high capital ratio based in a weaker banking system would be assigned a lower rating for capital adequacy than a bank with the same ratio in a stronger system. More simply, the country(ies) where a financial institution has its credit exposures can affect a given bank's probability of default. We therefore support the Committee's consideration of incorporating country risk as an additional driver as part of its ongoing assessment of the proposed framework.
- d.) The BCBS proposal for senior debt claims on banks assigns risk weights from a table ranging from 30-300% as a function of a bank's CET1 ratio and net Non Performing Asset ratios.

¹ Joint Forum Report on Credit Risk Management Across Sectors. <https://www.bis.org/bcbs/publ/joint37.htm>.

² Please see https://www.moodys.com/research/Banks--PBC_179038?WT.z_referringsource=BRM%7eMethodology. For more information surrounding the new methodology, see www.moodys.com/ratingbanks.

While asset quality and capital metrics are important risk drivers in assessing the stand-alone credit assessment of a given bank as discussed above, they are only the starting point when assessing the risk of senior debt claims.

In countries that operate an Operational Resolution Regime incorporating bail in (particularly the EU, Switzerland, and the United States), creditor risk relative to senior debt claims (operational liabilities, junior deposits and senior unsecured) will vary from bank to bank as a reflection of the liability structure of the obligor. In operational resolution regimes, the greater the subordination under senior obligations and the greater the volume of creditors in the same credit class, the lower the loss-given failure for senior creditors. We have captured this concept in the advanced Loss Given Failure (“LGF”) aspect of our new bank methodology³ as well as in the creation of a Counterparty Risk Assessment to capture the risk of loss on unsecured operational liabilities. LGF highlights that for a given amount of losses, senior creditors of banks with greater subordination may see their risk of loss in the event of failure decline (e.g. senior unsecured ratings get uplifted) versus the exposure senior creditors would face when they have invested in bonds with little or no subordination below them (e.g. senior unsecured ratings get notched down). We believe ratios should be updated to take into account developments in recovery and resolution regimes. Taking the above into account, we do not believe that there is a one size fits all approach to assessing risk to senior creditors without consideration of the liability structure of a bank.

3. General Observations (and the objective of consistency)

MIS’ analysis incorporates banks’ capital ratios which rely on BCBS metrics (e.g. RWAs). More accurate and consistent metrics would therefore assist MIS to better analyse and compare banks both regionally and globally. It would similarly benefit investors understanding of a bank’s capital adequacy.

The calibration of parameters is key to the credibility of the revised Standardised Approach. We agree with the view that RWAs at IRB-banks has led to “RWA optimisation” with models potentially underestimating risks if not properly designed and/or calibrated. We therefore support the call for action from the BCBS including the implementation of the capital floors which should assist in addressing this issue. It is important to adequately reflect the relative risks entailed with banks’ operations and exposures with the RWA calculations having systemic importance. The suggested ranges for RWAs on exposures to banks, the corporate sector and mortgages are also more precise than under the current Standardised Approach.

4. The Impact on the Capital Floor

The calibration of the Standardised Approach will serve as the anchor for the calculation of capital floors. In light of this, we believe that the reliance on capital floors, which aim to address model risk

³ See the Structural and Support Analysis Section of the New Bank Methodology.

and address the issue of comparability across banks, should not preclude an in-depth assessment/validation of banks' internal models. Furthermore, if the capital floors are to become a key building block of capital frameworks going forward, it is crucial that capital floors are computed similarly across jurisdictions so as to achieve consistency and a level playing field, which has so far not been the case.

Regarding the calculation of the floors, the two suggested approaches – by risk category – or based on total RWAs – appear to achieve the objective of reducing the benefits of the IRB approach and a convergence of both the IRB and Standardised Approach. That said, the approach by exposures seems to be more precise yet will make external communication more complex. While supportive of the overall approach, we are concerned about the implications of the adoption of the capital floors on banks' public disclosures. We anticipate that banks that will have a CET1/Tier 1 below the level of the floor will not necessarily publish their floored CET1/Tier1 unless they are required to do so. We would suggest that this information be included in banks' mandatory disclosures.

Finally, banks' reliance on models brings significant value to the extent that they have to rely on them not solely for computing RWAs (regulatory purposes) but also for risk management purposes ("use test"). As a result we believe that the legitimate objective of giving more weight to both the Standardised Approach and the capital floors should not result in undermining the greater understanding of risk that the use of models within the Basel 3 framework may bring to the business. This could occur if the floor were to be set too high, thereby limiting the benefit of adopting models. The upcoming QIS will help address this issue and quell any concerns in this area.

MIS would like to thank the BCBS for the opportunity to provide its views on the revisions to the Standardised Approach. We would be pleased to discuss our comments further with the BCBS.

Yours sincerely

A handwritten signature in dark ink, appearing to read "F. Drevon", with a stylized flourish at the end.

Frederic Drevon
Managing Director – Global Banking