

11 March 2016

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

**Response to the BCBS on its proposed revisions to the Standardised Approach for Credit Risk**

By upload to: <https://www.bis.org/bcbs/commentupload.htm>

**Moody's Investors Service Comments on the Basel Committee's second consultative document on revisions to the Standardised Approach for credit risk**

Moody's Investors Service (MIS) welcomes the opportunity to provide comments on the Basel Committee for Banking Supervision's ("BCBS") revised proposals for the Standardised Approach ("SA") for credit risk. We would like to bring to your attention two areas for further consideration:

— *Exclusion of government support from bank ratings*

We do not believe a change in the reference point in bank capital requirements to credit assessments that excludes (rather than includes) the possibility of government support would reduce the credit linkages between banks and sovereigns.

Having said that, it is possible to disaggregate MIS' credit ratings into approximations of their component parts, one of which is "government support" and the other is a measure of credit risk, absent the possibility of support.

— *Use of credit ratings*

MIS continues to support efforts that encourage market participants to form their own views of credit risk. More pointedly, we have been supportive of the Financial Stability Board's initiatives to reduce mechanistic reliance on external credit ratings in regulation. We suggest the BCBS might consider to further bolster the importance of the diligence requirements proposed under Pillar 1.

We set out our comments in more details below.

**1. Exclusion of government support from bank ratings used in determining capital requirements**

*a. Exclusion would not reduce sovereign-bank credit linkages*

Banking and sovereign credit risks are inherently linked (i.e., positively correlated) for many reasons, but the use of credit risk assessments inclusive of government support in the determination of bank capital charges is not likely one of them. The credit risk profile of the banking system may vary directly with the credit risk profile of the sovereign for the following reasons:

- They share common macroeconomic drivers of credit risk (such as the pace of GDP growth);
- The weakening of the banking system can reduce the availability of credit and other banking services and cause a weakening of the economy, which in turn can weaken the sovereign's credit profile;
- Rising sovereign distress for, including in the extreme a default by, the sovereign can weaken the banking system's credit profile if (i) banks hold the sovereign's bonds or (ii) banks have extended credit to other borrowers who are dependent on the sovereign for funding;
- Rising sovereign distress can, through a myriad of additional ways, worsen the macroeconomic environment and bank loan performance; and
- a weakening of the sovereign's credit profile may reduce the ability of the sovereign to provide support to private sector borrowers, including banks, in times of systemic crisis.

These linkages between sovereign and banking sector risk are not affected by the proposed shift in the reference point for the assessment of bank credit risk. In this context, basing

bank capital charges on credit assessments that exclude government support, rather than include support, will not reduce the correlation between sovereign and bank credit risk.<sup>1</sup>

*b. Removing government support from our bank credit assessments is feasible*

Government support is one factor when analysing banks' credit risk. Government support assumptions are incorporated in our rating process after determining a bank's standalone credit profile, the possibility of support from affiliated entities, and differences in likely loss rates on rated instruments resulting from levels of subordination and instrument tranche size ("Loss Given Failure"). It is possible to disaggregate the component parts of a credit rating; for example MIS publishes the following assessments:

- The Baseline Credit Assessment (BCA) provides an assessment of a bank's creditworthiness which hinges on both its own financial metrics and its "macro profile", which represents the strengths and weaknesses of its operating environment. The BCA speaks to the likelihood of a bank defaulting, absent any extraordinary support from an affiliate or a government.
- The Preliminary Rating Assessment (PRA), which incorporates the BCA, affiliate support, and Loss Given Failure, while excluding government support. PRAs are assigned at the liability class level.

Although these measures, and in particular the PRA, may be seen as proxies for a rating that excludes government support, substituting the credit rating with the PRA might lead to capital charge distortions for two reasons.

- **Relevant regulatory framework:** While some countries have introduced operational resolution regimes to end bail-out, others have refrained from doing so, reflecting a preference to maintain *ad hoc* supervisory flexibility as to how to deal with failing banks. Our rating approach reflects this distinction. By making an assumption that sovereign support would not be forthcoming, the BCBS would ignore the relevant regulatory framework applicable to those banks.
- **Hierarchy of instruments:** In jurisdictions with operational resolution regimes, the sequence in which losses would be absorbed is relatively more important than in countries where an institution might benefit from government support before any losses are assigned to bond holders. This means that our PRAs on senior debt are currently relatively higher in countries with operational resolution regimes (and government support relatively lower), than in countries without operational resolution regimes.

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<sup>1</sup> As a substantive matter, we can think of no instance in which the recalculation of bank capital charges related to a bank's exposure to other banks following a sovereign downgrade and downgrades of other banks has played a role in Moody's re-ratings of banks.

Removing government support without re-evaluating support provided by subordinated liabilities may lead to inconsistent outcomes for otherwise similar banks.

The annex to this cover letter provides more detail on our approach to rating banks and our current government support assumptions.

## **2. The proposed use of external credit ratings**

MIS has been supportive of the extensive work undertaken by the BCBS, other standard-setting bodies, and national authorities to reduce the mechanistic use of external credit ratings in regulation. Any single indicator of creditworthiness has the potential to cause inadvertent consequences.

MIS also agrees with the BCBS' objective of designing a system that displays a sufficient degree of risk-sensitivity but which avoids being overly complex. We take note of the BCBS' proposal to reintroduce external credit ratings, though in a non-mechanistic manner, as banks would be required to undertake due diligence for assessing the creditworthiness of their counterparties in order to mitigate the pitfalls involved with mechanistic reliance on external ratings. Basel may wish to consider further encouraging banks to form their own credit risk views by bolstering due diligence requirements or allowing additional alternative credit measures that could supplement the use of credit ratings.

Yours sincerely,

/s

Frederic Drevon  
Managing Director – Global Banking

## **Annex: Moody's approach to rating banks and assessing potential government support**

In line with new legal frameworks that foresee “bail in” and seek to end “bail out”, MIS has significantly reduced sovereign support assumptions in our credit ratings in countries that in our view have operational resolution regimes in place. We, however, have not entirely eliminated support assumptions in countries with operational resolution regimes as we consider there are scenarios where some element of government support might still be provided.

This could be the case either during the transition period, or even at the end state when requirements for Total Loss Absorbing Capital or Minimum Requirements for Own Funds and Eligible Liabilities have been met. For example, a given bank's loss absorbing resolution capital may be deemed insufficient in an absolute sense; in these cases a bail-out might follow a bail-in. Alternatively, the authorities might see some classes of liabilities at risk that they do not wish to bail in.

Further, not all jurisdictions have operational resolution regimes that provide authorities with a bail-in tool and we continue to assume a considerable likelihood of bail-out in these jurisdictions.

In any case, the way in which we assume potential government support is never mechanical, but undertaken individually for each bank and indeed, for each class of liabilities. For this we take into account the legal framework as well as an institution's structure and ownership, and other idiosyncratic factors.

In countries with operational resolution regimes, most banks do not get any uplift. Practically speaking, our assessment of government support in those jurisdictions can be roughly categorised as follows:

- For the most systemically relevant banks (i.e. Global Systemically Important Banks, GSIBs, and some Domestic Systemically Important Banks, DSIBs) we typically assume one notch uplift in the ratings of long term senior debt and deposits at the bank operating company level. We no longer typically incorporate government support in holding company ratings nor in ratings for subordinated debt at the bank operating company level.
- We might assign up to three notches of uplift for banks with a public policy purpose.
- Banks in resolution, wind-down or under restructuring are assessed on a case by case basis.
- For other banks we generally assume a low (but not zero) probability of support, which does not normally result in any rating uplift.

**Exhibit 1: Distribution of notches of government support incorporated in bank deposit ratings**

| % of banks                                     | # in sample | Notches of government support in deposit rating |            |            |            | Total       |
|------------------------------------------------|-------------|-------------------------------------------------|------------|------------|------------|-------------|
|                                                |             | 0                                               | 1          | 2          | 3+         |             |
| Systems with operational resolution regimes    | 304         | 69%                                             | 28%        | 2%         | 1%         | 100%        |
| EU and Other Western Europe                    | 242         | 64%                                             | 33%        | 2%         | 2%         | 100%        |
| United States                                  | 62          | 92%                                             | 8%         | 0%         | 0%         | 100%        |
| Systems without operational resolution regimes | 519         | 47%                                             | 18%        | 16%        | 18%        | 100%        |
| <b>Total</b>                                   | <b>823</b>  | <b>56%</b>                                      | <b>22%</b> | <b>11%</b> | <b>12%</b> | <b>100%</b> |

*Notes: Data is drawn from Moody's published Credit Opinions as of February 11, 2016. Sample comprises principal banks where a standalone BCA analysis is conducted and excludes ratings on instruments issued by special purpose vehicles.*

Exhibit 2: Outline of the sequential analysis followed in MIS' bank rating methodology

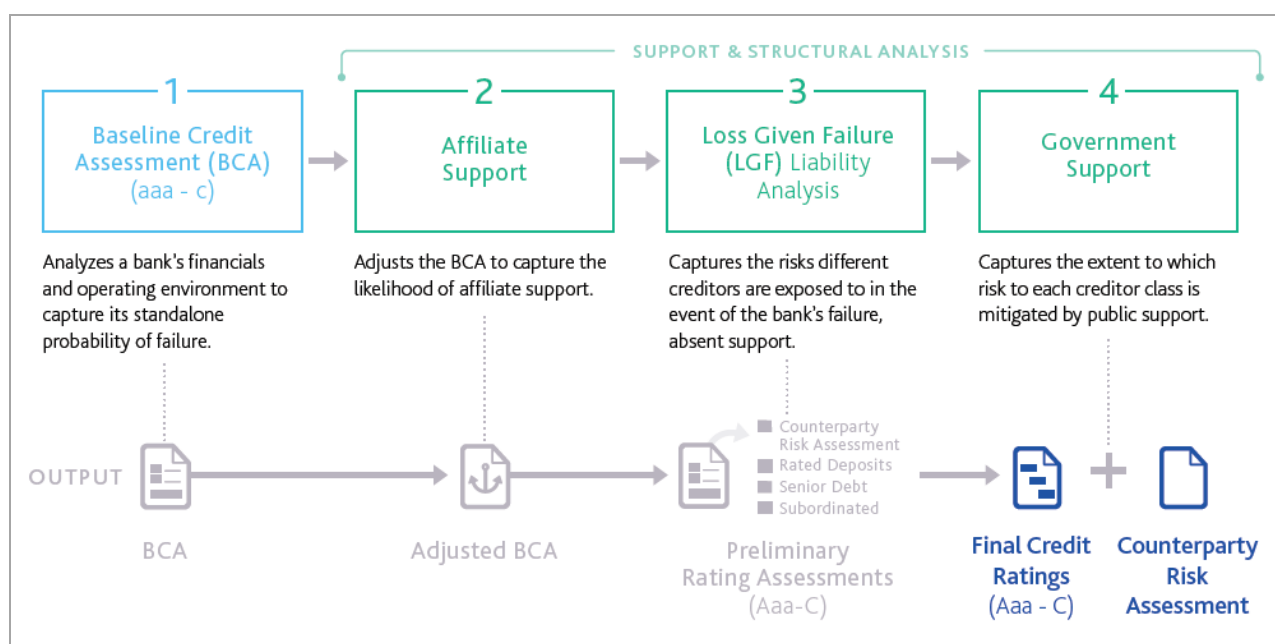


Exhibit 3: Schematic of MIS' approach to assessing a banking system's Macro Profile

