STANDARD & POOR'S
RATINGS SERVICES
McGRAW HILL FINANCIAL

RatingsDirect®

The Proposed Revised Basel Standardized Approach For Credit Risk May Add Complexity Without Improving Standards

Primary Credit Analysts:
Alexandre Birry, London (44) 20-7176-7108; alexandre.birry@standardandpoors.com
Mathieu Plait, Paris (44) 20-7176-7074; mathieu.plait@standardandpoors.com

Secondary Contact:
Bernard De Longevialle, New York (1) 212-438-0287; bernard.delongevialle@standardandpoors.com

Corporate Criteria Officer:
Peter Kernan, London (44) 20-7176-3618; peter.kernan@standardandpoors.com

Table Of Contents

EXECUTIVE SUMMARY

Is The Improved Granularity Illusory?

The Credit Impact Would Be Minimal

Our Responses To Selected Questions From The BCBS' Consultation Paper

Related Criteria And Research

The Proposed Revised Basel Standardized Approach For Credit Risk May Add Complexity Without Improving Standards

EXECUTIVE SUMMARY

(Editor's note: The following is Standard & Poor's Ratings Services' response to the Basel Committee on Banking Supervision's consultative document "Revision to the Standardised Approach for credit risk," issued on Dec. 22, 2014. The views expressed in this response represent those of Standard & Poor's Ratings Services and do not address, nor do we intend them to address, the views of any other affiliate or division of Standard & Poor's Financial Services LLC. We intend our comments to address the analytical needs and expectations of our credit analysts, as well as the questions we receive from investors. Our comments on the consultative document do not affect our ratings criteria.)

Standard & Poor's Ratings Services believes the Basel Committee on Banking Supervision's (BCBS) proposed revision to the standardized approach (SA) for assessing banks' credit risk, which it released for comments in December 2014, may not--in its current form--necessarily improve its risk sensitivity, despite seemingly greater granularity. However, combined with other ongoing regulatory initiatives, some of the proposal's objectives—such as reducing national discretion over the risk weights applied on certain credit exposures and reducing inconsistencies between the SA and internal model-based approaches—could help alleviate certain shortcomings of the current regulatory bank capital metrics.

The consultation sets out proposals to revise the calibration and the calculation of regulatory capital requirements under the SA for exposures to banks, corporate entities, retail assets (such as exposures secured by residential real estate), multilateral development banks, and other assets, as well as past-due loans and off-balance-sheet exposures. It also proposes amendments to the treatment of credit risk mitigation under the SA. Among other things, it proposes to remove most of the existing references to external credit ratings, introduce the use of simple metrics to determine capital requirements for certain asset classes, and better differentiate capital requirements within and among asset classes.

Overview

- Some of the objectives of the BCBS' proposed revisions to the standardized approach for credit risk, such as increasing the comparability of regulatory capital requirements between the different approaches and recalibrating the risk weights, combined with other ongoing regulatory initiatives, could help reduce some shortcomings of the current regulatory capital metrics.
- However, in seeking to reduce the framework's reliance on external credit ratings, the proposal increases its reliance on metrics that are not always publicly available in a timely manner and could be measured inconsistently. These metrics generally don't take into account the full range of factors that can affect the creditworthiness of a corporate or bank exposure, in our view, potentially undermining the framework's risk sensitivity and robustness.
- We support the objective to improve the granularity of capital requirements for retail exposures, although the BCBS will need to adjust the calibration of risk weights in the final version of the proposal, in our view.
- We expect the potential overall impact on bank ratings to be limited, although it will depend, among other things, on banks' responses to the changes, including the extent to which the revision encourages some banks to strengthen their capitalization according to Standard & Poor's risk-adjusted capital (RAC) measure of capital adequacy, and how much it affects an entity's business model or risk appetite.
- We expect, for instance, that the regulatory risk-weighted assets (RWAs) of banks with large mortgage portfolios with relatively high loan-to-value ratios could increase significantly--either directly for banks under the SA, or indirectly for banks under IRB approaches (through the capital floors proposed in a parallel consultation of the BCBS).
- We believe potential volatility in RWAs could dampen investors' appetite for certain subordinated instruments, at a time when banks are aiming to ramp up these buffers to address other concurrent regulatory developments. However, enhanced Pillar 1 requirements may, in some cases, reduce the need for Pillar 2 add-ons (which are often less transparent) and restrain the volatility in RWAs.

We fully support the BCBS' objective to improve the consistency and comparability of regulatory risk-weighted assets (RWAs). Given the unavoidable limitations of any single capital metric, whether leverage-based or risk-sensitive, we continue to see an important role for more than one regulatory capital metric to provide more insight into capitalization. However, we will continue to use our risk-adjusted capital (RAC) ratio as our key metric to analyze banks' capitalization, given its comparability across banks, and supplement this with our assessment of each bank's risk position. In our view, the proposals aim to address some of the weaknesses of existing risk-sensitive regulatory capital ratios. Notably, we welcome the proposal to recalibrate the risk weights, to align definitions between the SA and internal ratings-based (IRB) approaches, and to reduce national discretion about risk weights for certain exposures, such as mortgages. This could, to some extent, improve the comparability of regulatory capital requirements and ratios between banks using different approaches. We also support the objective to introduce more granularity than in the current treatment when assessing capital requirements for retail exposures, although the BCBS will need to adjust the calibration of risk weights in the final version of the proposal, in our view. For corporate and bank exposures, we believe the metrics the BCBS is proposing to replace references to external credit ratings will generally be less risk-sensitive and more complex to implement, and may render regulatory capital requirements more procyclical than under the current framework (i.e., when the economy is down, capital requirements will generally be higher, and vice versa).

We believe that the possible impact of this consultation must be viewed in the context of a comprehensive range of revisions by the BCBS that also aim to improve the overall regulatory capital framework, including:

- The concomitant consultation on standardized capital floors for banks using IRB models, titled "Capital floors: the design of a framework based on standardized approaches," which could, in our view, reduce cases of large variations in regulatory ratios and increase comparability between banks using the SA and IRB approaches;
- The "Fundamental review of the trading book: A revised market risk framework" consultation;
- Revisions to the Basel securitization framework (see “Securitization Regulation In Focus: Proposed Revisions To The Basel Framework Could Deter Banks From Investing In European Securitizations,” published on April 3, 2014, on RatingsDirect); and
- The revised Pillar 3 (Market Discipline) disclosure requirements.

To the last point, we believe that better and more standardized disclosures will be a key tool to improve the markets' confidence in regulatory capital metrics, given the unavoidable limitations of any single metric. More consistent and systematic disclosure of asset quality indicators for each asset class, and by the main geographies, would allow market participants to back-test and challenge banks' calibrations and would support market discipline.

Is The Improved Granularity Illusory?

We're not convinced that the proposals will necessarily improve the risk-sensitivity of the SA. We support the aim to reduce mechanistic reliance on external credit assessments but believe that substituting ratings with measures that are potentially too simplistic would not, in our view, lead to better, more robust regulatory standards. We note that under the current SA, often the majority of capital requirements already originate from exposures for which external ratings do not determine the risk weights (e.g., exposures to certain international organizations, retail exposures, exposures in default, exposures associated with particularly high-risk equity, and some other items). Also, other elements of the existing capital framework, such as the use of stress-testing and other possible Pillar 2 (Supervisory Review Process) requirements, as well as the introduction with Basel III of the leverage ratio as a back-stop measure, already reduce the risk of sole and mechanistic reliance on external ratings, even for banks extensively using the SA.

Regarding the proposed use of the common equity Tier 1 (CET1) ratio and a net nonperforming asset (NPA) ratio as substitutes for external ratings, we believe these ratios are inconsistent indicators of creditworthiness. This is especially true for the net NPA ratio where we see huge inconsistencies in its computation that goes beyond the difference in accounting standard. Moreover, relying on these measures alone omits a number of key drivers of a bank's risk profile; these include the influence of its operating environment, the nature of its ownership, the strength of its franchise, the stability of its revenue base, and its funding and liquidity profiles, to name just a few. We would welcome the disclosure of the study mentioned in the consultation to substantiate these metrics' ability to predict bank failures. We believe that our bank ratings continue to show a clear correlation with default, as our default studies for financial institutions have demonstrated (see “2013 Annual Global Financial Institutions Default And Rating Transition Study,” published Nov. 24, 2014). These ratings--which incorporate a wide range of risk factors, in accordance with our criteria--are under constant surveillance and express relative credit risk in a simple and widely recognized manner. In our view, the risk-sensitivity of the SA under the proposal, for bank exposures, will depend largely on the progress all banks globally make in transitioning toward consistent, directly comparable measures, and on the frequency and

timeliness of disclosure of these metrics. But even so, given the delays in disclosure and differences in frequency of disclosure, the data a bank uses to calculate its ratios may in some cases be as much as six months old.

As for the proposed risk weights for corporate exposures, we believe that while using financial risk measures is helpful when performing a line-by-line risk-weighting, the proposed exclusive use of financial risk measures (revenue and leverage, defined as total assets and total equity, respectively) presents some challenges as it will overlook important non-financial determinants of default risk. In our view, these challenges may be magnified for insurers, whose balance-sheet sizes may have very different implications for risk than they would for other corporate entities.

For non-insurance corporate entities, we view the use of financial risk measures without assessing the business risks, such as country, industry, and competitive risk, or other areas of analysis, such as management and governance, will overlook the sustainability of the company's business position, which drives the level and volatility of its profits. Standard & Poor's believes that a corporate entity's business position is the foundation for its economic success and strongly influences the amount of financial risk or debt and interest that the company can support and the relative default risk the entity faces.

We believe that the corporate entity's business risk, the level and volatility of its earnings, the size of its cash flows relative to its financial obligations (interest payments and principal repayments), and its liquidity, historically, currently, and on a forward-looking basis, are all important measures of corporate risk. Furthermore, we believe that credit protection measures such as debt-to-EBITDA ratio, funds from operations-to-debt, and operating cash flow-to-debt ratio could be more informative measures of corporate financial risk than revenues or leverage alone, and that the debt measure should include off-balance-sheet debt (such as operating leases) and on-balance-sheet debt-like obligations (such as pension deficits).

For retail exposures (including mortgages, auto loans, credit card debt, and small and medium enterprise retail, among others), we believe the proposed greater segmentation of risk among asset types could support greater risk sensitivity. We believe the proposal could go further, however, with additional distinctions between auto loans, which we view as typically less risky than average retail exposures, and other retail and revolving exposures, such as credit card exposures, that we view as more risky. However, the proposed differentiation of mortgage risk-weights according to a debt service coverage (DSC) ratio and the loan-to-value (LTV) metric may not, in our view, lead to the intended greater risk sensitivity. In our view, the proposed calibration is based on a potentially excessive correlation of risk weights with LTV. We believe other factors that the current proposal doesn't consider may have a greater influence on the credit risk of mortgage exposures; these include the legislative framework (for instance, the repossession framework, the existence of a personal insolvency regime, and creditors' ability to access a borrower's other assets or income streams in the event of default), the nature of the loan (e.g., owner-occupied, self-certified, or buy-to-let), or the existence of guarantee mechanisms. We believe that these factors may outweigh DSC and LTV in some cases, thereby making comparisons between banks and between jurisdictions less meaningful. We also question the comparability of these ratios among banks, which may measure them differently and vary in how often they're able to update these measures over time (due to variations in property price indexation and the frequency of borrowers' income updates, for example).

An alternative to the proposed revised SA and the use of simple metrics would be to differentiate the risk weights by

asset class (as is already the case under the current framework) and by geography, similar to what we do under our RAC framework. Within an asset class, the risk weights could be based on macroeconomic indicators that are readily available to everyone and updated frequently and in a timely manner. This would keep it simple while substantially improving the risk-sensitivity of the SA when compared with the use of the suggested metrics, in our view.

The Credit Impact Would Be Minimal

We expect the impact of the proposed revision on bank ratings to be limited overall, but it will depend on banks' strategic responses to the final calibration of the risk weights themselves and on the metrics used to determine the risk weights. In our analysis of capital and earnings under our bank rating methodology, we first assess how a bank performs against its regulatory requirements; then we use our own measure of risk-based capital adequacy, our projected RAC ratio, to form our opinion of a bank's future capital position. If the proposal leads to further capital building by a given institution, this may underpin an increase in our projected RAC ratio, which could in turn cause us to revise our assessment of that entity's capital and earnings. Conversely, depending on the final calibration of risk weights, the proposal could lead some banks to take on more risk to maximize returns if the standardized risk weights increase, which in turn could hurt our assessments of their risk positions. It's also possible that the revisions will constrain specific banks' ability to compete in certain segments (e.g., high-LTV mortgages) or prompt banks to transfer certain assets to the nonbank sector if they deem them uneconomical, which would also factor into our assessments of banks' business positions. Finally, at the debt-type level, the proposal could affect certain hybrid capital issue credit ratings where there are mandatory regulatory capital-based triggers, assuming no change in a bank's SACP, in cases where it leads to a material increase in RWAs. Such an increase—unless offset by regulatory capital building--would shorten the distance to the trigger threshold for instruments that include a mandatory nonpayment or conversion clause based on a going-concern trigger that is in turn derived from regulatory capital ratios.

The proposal's impact on regulatory RWAs will likely differ greatly among banks and jurisdictions, but we expect that in general, RWAs would increase rather than decrease. Naturally, we expect the greatest direct impact from the proposal on banks using the SA, which are often smaller banks globally but include a number of larger banks in Asia-Pacific and Latin America—particularly those with large mortgage portfolios with relatively high LTVs. "Challenger" banks that focus on mortgage lending in certain European countries could also feel a strong impact, in our view, because we believe the risk weight for mortgages under the SA could see a significant jump.

However, the impact will not be limited to banks using the SA. As a result of the parallel BCBS consultation on standardized capital floors for banks using IRB approaches, depending on the final calibration of these floors (see "The Basel Committee Proposal For Standardized Regulatory Capital Floors Is A Useful Concept, But Calibration Will Be Key," published March 27, 2015), the SA revision could also indirectly (and perhaps significantly) affect banks using IRB approaches. We note, for instance, that for a number of European banks, the average risk weights assigned to mortgages are frequently in the low teens and sometimes even lower, compared with the 35% flat rate under the current SA. We do agree that such IRB risk weights are too low, and factor under our RAC framework risk weights for mortgages of 19% in the lowest-risk countries, increasing to 30% or more for a number of systems. With the proposal, for some countries (such as the Netherlands and Sweden), where LTVs frequently exceed 60%-70%, irrespective of the

bank's credit risk track record, risk weights under the SA could increase to around 60% for certain banks under the current proposal. Depending on the calibration of floors, overall regulatory capital requirements even for banks using IRB approaches could increase, possibly beyond what we use in our RACF approach.

We expect the proposal to have little to no impact on U.S. banks. U.S. banks using internal models also have to report SA capital requirements, and the binding constraint is the higher of the two, according the Dodd-Frank Act and the Collins Amendment. We also note that the U.S. has already implemented an amended version of the SA, which bears broad similarities with some of the BCBS' proposed revisions.

We also expect that the revised SA will, in some cases, reduce the need for Pillar 2 add-ons (additional capital charges applied by national regulators), which are often not transparent to market participants. Indeed, some of the new proposed requirements, such as higher risk weights for exposures secured by real estate than under the current framework when the counterparty credit risk is high, reflect some of the Pillar 2 add-ons some regulators currently apply.

All in all, while we question whether the current proposal will achieve greater risk sensitivity and a better risk assessment, we agree with its main objectives. We believe the BCBS' quantitative impact study will be key to understanding the proposal's potential implications, and its possible limitations.

Our Responses To Selected Questions From The BCBS' Consultation Paper

We've provided our responses to several key questions from the BCBS' consultative document (some of which we've grouped together). The question numbers reflect those in the committee's paper.

Exposures to banks

Q1. What are respondents' views on the selection of the capital adequacy ratio? In particular, is the CET1 ratio superior to the Tier 1 ratio or the Leverage ratio? Do respondents agree that it is necessary to require calculations in accordance with Basel III in order to ensure a consistent implementation?

Q2. Do respondents believe the net NPA ratio is an effective measure for distinguishing a bank exposure's credit risk? What alternative asset quality measure, if any, should be considered by the Committee?

Q4. Do respondents have suggestions on how to address these concerns on the treatment of exposures to banks? In particular, do respondents have views on how to treat exposures to banks not subject to Basel III in a consistent and risk-sensitive manner?

We believe that the proposed use of the CET1 or Tier 1 ratio combined with a net NPA ratio as a substitute for external ratings could undermine the risk-sensitivity of the framework to some extent, at least for now. We believe that the reliability of these indicators will depend largely on the progress all banks globally make in transitioning toward more consistent, comparable regulatory measures, and on the frequency and timeliness of disclosure of these metrics. Indeed, to adequately assess risks, all banks would need to disclose those ratios and calculate them on the same basis, without material national discretion. Currently we see inconsistencies in the CET1 ratio calculation, but those are even bigger when it comes to NPAs where the inconsistencies go beyond the differences in accounting standards. Indeed,

there are big variations regarding the recognition of NPAs even between banks using the same accounting standards. We note that this measure would penalize the most conservative banks, which tend to more proactively classify doubtful loans in NPAs and extensively apply contagion rules. A common definition of NPAs and a common policy of NPAs recognition will be essential.

We note that many jurisdictions are still far from implementing Basel III; according to the BCBS' latest "Implementation of Basel standards" report, which covers 109 jurisdictions, 20 jurisdictions have made no progress toward implementing Basel III. But even so, given delays in disclosure and differences in the frequency of disclosure, the data (NPA and CET1) a bank will use to calculate its risk weights may, in some cases, be as much as six months old. Such delays could underestimate the risk associated with a bank exposure in situations where capital ratios could evolve rapidly within six months, such as during the last financial crisis. Furthermore, we believe that the NPA ratio's relevance as a risk indicator depends, among other things, on the entity's business model; for a number of investment banks, for instance, we believe an NPA ratio wouldn't accurately capture shifts in risk exposures.

In our view, the leverage ratio could be a useful addition to the risk-weighted ratio, but not a substitute for it. We continue to believe that using the leverage ratio as a primary comparative measure of capitalization for banks could lead to erroneous conclusions.

We believe a bank's creditworthiness depends on a range of factors that go well beyond capital adequacy and asset quality. The emphasis on these two metrics omits a number of significant drivers of a bank's risk profile, in our view, such as its operating environment, the nature of its ownership, the strength of its franchise, and the stability of its revenue base, along with its funding and liquidity profiles, to name just a few. Our bank ratings, which incorporate these factors, support this view and indicate that banks' creditworthiness has limited correlation with the two current regulatory capital and NPA measures (see charts 1 and 2). The consultation paper recognizes that more effort is needed to improve the consistency of these metrics. However, it's difficult for us to assess whether their risk-sensitivity will improve sufficiently to enable these metrics to serve as proxies for banks' overall creditworthiness.

Chart 1

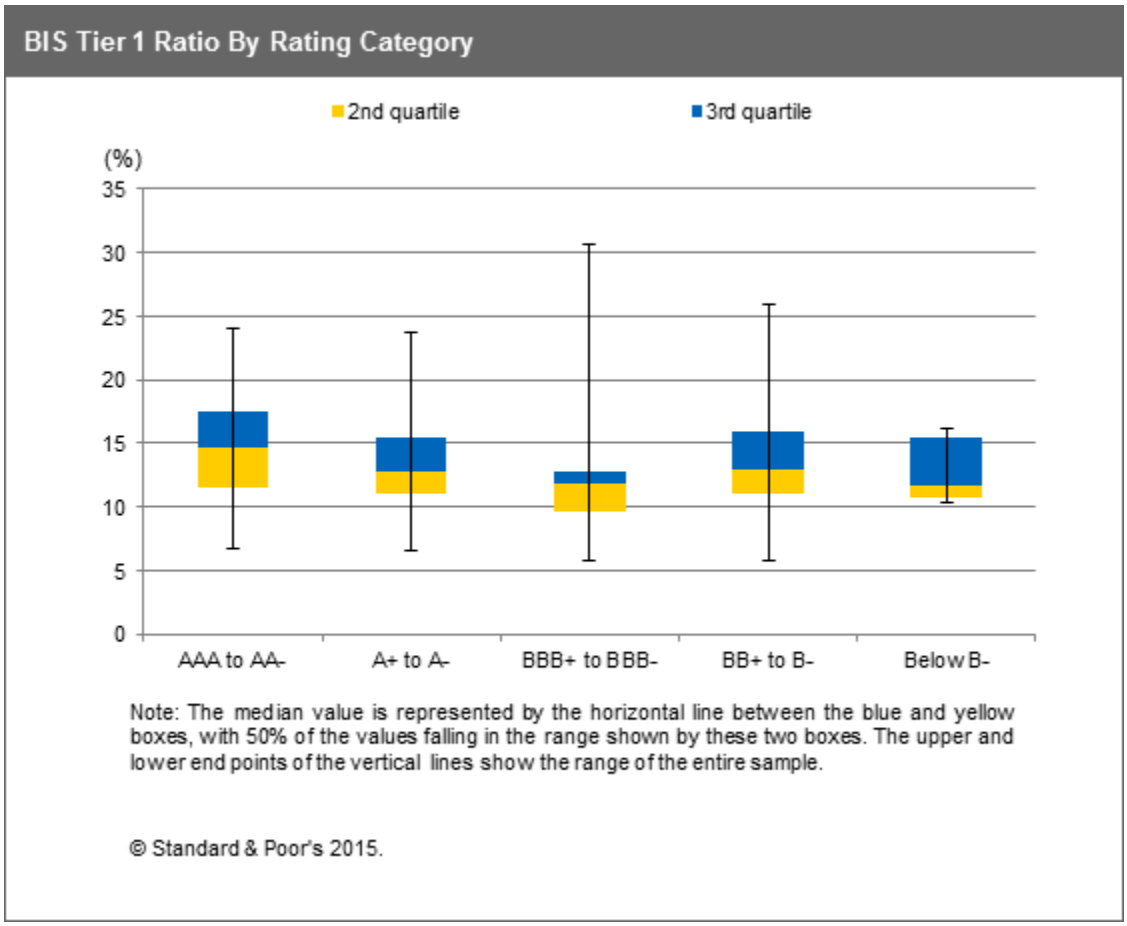
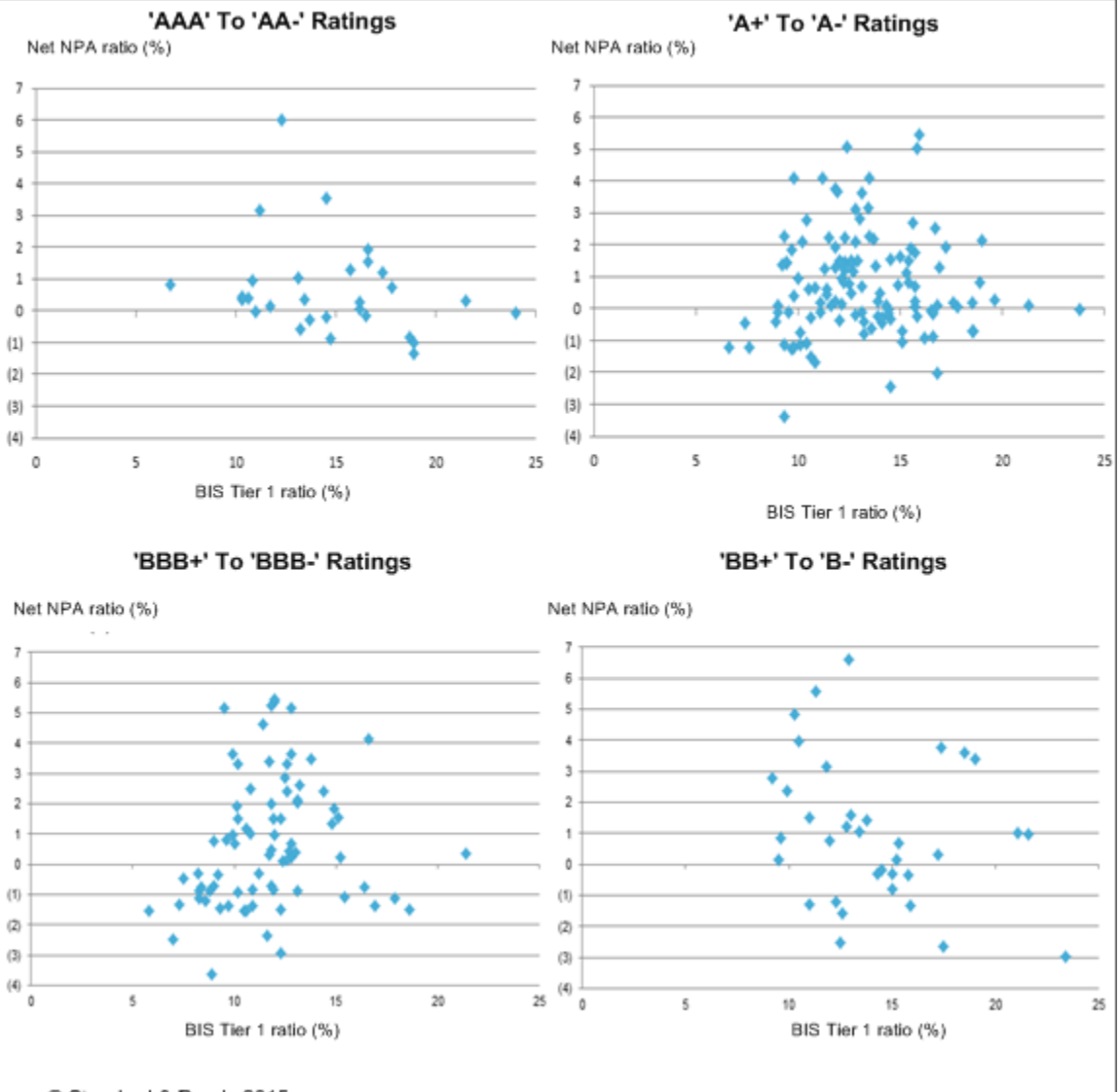

BIS Tier 1 Ratio By Rating Category
2nd quartile
3rd quartile
(%)
35
30
25
20
15
10
5
0
AAA to AA-
A+ to A-
BBB+ to BBB-
BB+ to B-
Below B-
Note: The median value is represented by the horizontal line between the blue and yellow boxes, with 50% of the values falling in the range shown by these two boxes. The upper and lower end points of the vertical lines show the range of the entire sample.
© Standard & Poor's 2015.

Chart 2
Net Nonperforming Asset Ratio And Bank of International Settlement Tier 1 Ratio By Rating Bucket



Our bank ratings are widely recognized, easily accessible, and simply presented benchmarks of relative creditworthiness, in our view, and they are under constant surveillance. Our default studies for global financial institutions corroborate that our ratings continue to show a clear correlation with defaults (see chart 3 and "2013 Annual Global Financial Institutions Default And Rating Transition Study," published Nov. 24, 2014). For instance, the Gini ratios, which we calculate regularly by plotting the cumulative share of defaults against the cumulative share of issuers in a Lorenz curve, indicate that ratings are effective indicators of relative default risk (see chart 4).

Chart 3

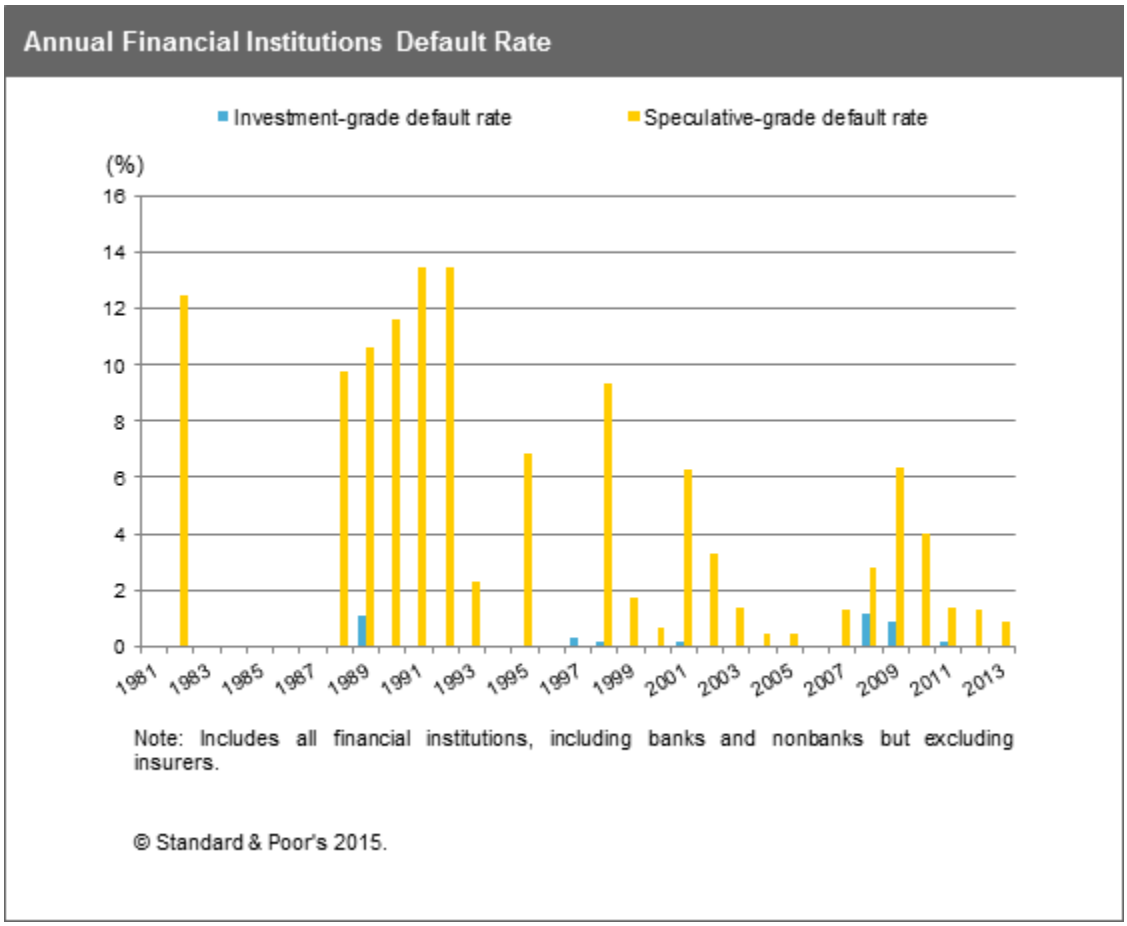
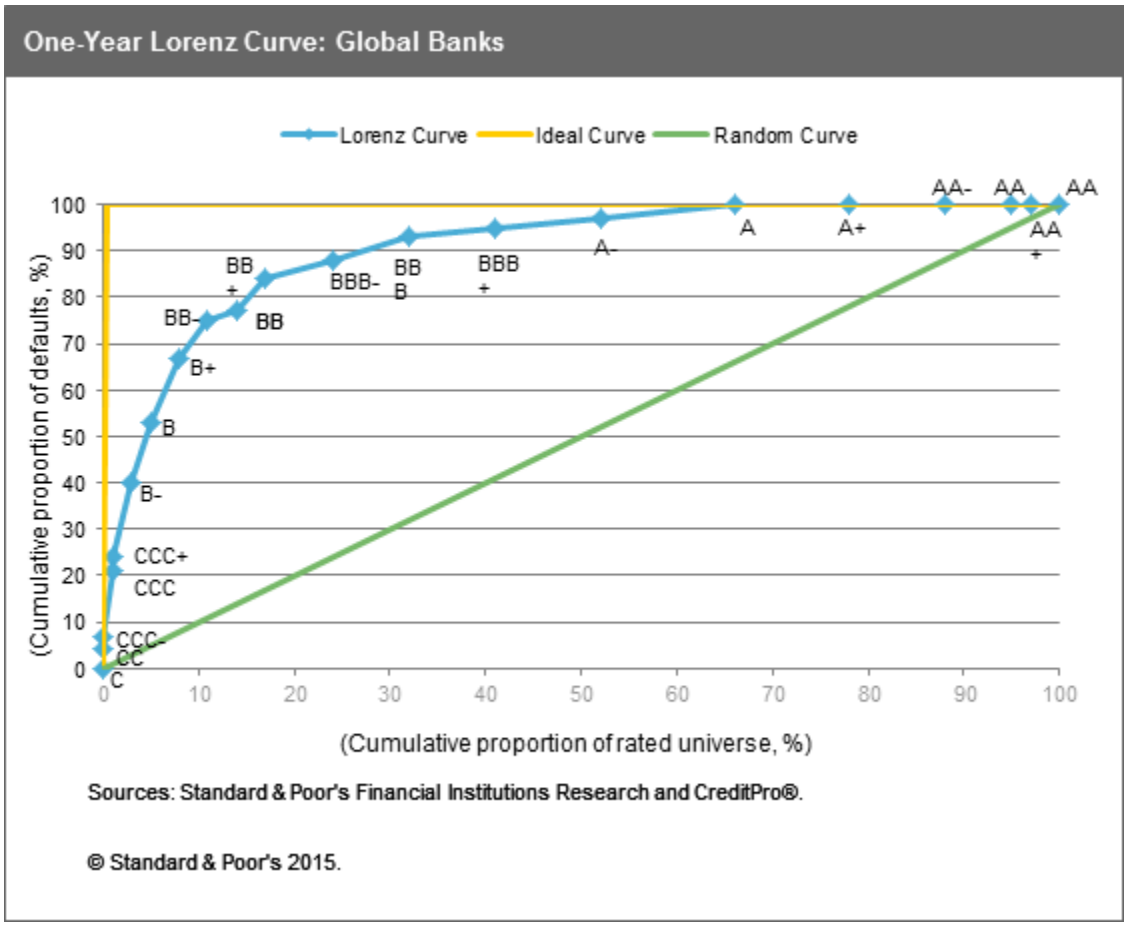


Chart 4

One-Year Lorenz Curve: Global Banks



We don't have any particular concerns about the general calibration of risk weights attached to bank exposures, although we question whether the proposed 300% risk weight for a bank with a CET1 ratio of less than 4.5% is too lenient, because such an entity would be in breach of regulatory requirements.

Exposures to corporate assets

Q5. Do respondents have views on the selection of risk drivers and their definition, in particular as regards leverage and the incorporation of off-balance-sheet exposures within the ratio? Would other risk drivers better reflect the credit risk of corporate exposures?

Revenues are, of course, an important potential source of earnings and cash flows, and balance sheet leverage can signal how conservatively or aggressively a corporate entity has financed itself. However, whether a company is able to convert those revenues into earnings and cash flow that it can then use to meet its debt interest and principal payments depends on the level and stability of its costs and working capital, and on its EBITDA, funds from operations, and operating cash flow. Furthermore, the use of a balance sheet measure of leverage can mask differences in accounting standards between jurisdictions that affect the reporting of economically equivalent transactions. Moreover, accounting rules often provide options that can result in different treatments of certain items, even among companies using the same accounting standards. The use of financial risk measures derived from earnings and cash

flow-to-debt ratios would, in our view, be less prone to accounting influence.

We believe the use of prior-year revenue and leverage to measure and rank risk will also overlook other important determinants of corporate risk, and that forecasting and an assessment of management's financial policy may better capture potential changes in corporate risk.

In our view, a corporate entity's business position is the foundation for its economic success and strongly influences how much financial risk or debt and interest that it can support and the relative default risk the entity faces. For example, companies with strong competitive positions that operate in stable, regulated industries in jurisdictions with low country risk have significantly lower risk of default than, for example, those with weak competitive positions that operate in volatile, cyclical, highly competitive industries with high country risk, even if the companies have the same amount of earnings, cash flow, debt, interest costs, revenue, and leverage. The companies with lower business risk will benefit from greater earnings stability and a more stable equity buffer, and therefore will have lower default risk for a given level of absolute debt.

Furthermore, liquidity is a critical component of corporate risk, given that a liquidity shortfall could cause an otherwise healthy entity to default. Accordingly, we believe that liquidity risk is a critical risk characteristic of a company. We also believe that the inclusion of off-balance-sheet exposure (such as operating leases) and on-balance-sheet debt-like obligations (such as pension deficits) would enhance financial risk measures. Including such exposures and obligations would allow for more globally consistent and comparable measures, in our view.

Q6. Do respondents have views on the appropriateness of the proposed treatment, especially with regard to SMEs? And about the more lenient treatment for start-up companies?

Start-ups will typically have higher default risk than established companies, which generally benefit from more solid organizational infrastructure, market share, and revenues. As such, we believe the proposed risk weightings will not, in some cases, sufficiently account for the relatively lower risk of established companies. For example, we believe an established company with €999 million of revenues, solid profits and cash generation, and leverage greater than 5x will generally represent lower risk than a start-up, so using the same proposed 110% risk weight for both exposures would not accurately capture their relative risk.

Similarly, we believe that the proposed 250% risk weighting for subordinated debt will, in some cases, inaccurately calibrate the relative risk of senior and subordinated corporate debt. This is because the proposed risk weightings do not take into account the corporate entity's underlying business and cash flow strength, which, in our view, are among the principal determinants of default risk for both senior and subordinated debt. For example, the senior debt of the very weakest class of corporate entity (with, say, positive equity, revenues of less than €5 million, and leverage greater than 5x) would receive a 130% risk weighting, while subordinated debt issued by the strongest corporate (with, say, €10 billion of revenue, substantial profits and cash flows, and leverage between 1x and 3x) would receive a 250% risk weighting. In our view, a subordinated lender to a strong corporate issuer faces significantly lower default risk than a senior lender to a weak one, and the proposed risk weightings don't reflect this.

Q7. Do respondents think that the risk sensitivity of the proposal can be further increased without introducing excessive complexity?

Yes, and in several ways.

We believe that the use of a generally available measure of earnings or cash flow (such as EBITDA or operating cash flow) to debt, including off-balance-sheet and on-balance-sheet debt-like obligations, would enhance the corporate risk measures.

We also believe that independent, publicly available, and reputable measures of credit risk, could help to differentiate the relative risk of different asset classes.

In addition, we believe it may be appropriate to use sovereign credit assessments as a proxy for country risk (as the BIS already does) and to increase the corporate risk weightings for companies that are domiciled in or have significant exposure to countries whose sovereign credit assessment is 'BB+' or lower.

We also believe that the risk weighting of subordinated debt should be anchored to the corporate risk weighting, and that the subordinated debt of lower-risk corporate entities should have lower risk weightings than the senior and subordinated debt of higher-risk companies.

In addition, we believe that the corporate risk weights should be higher for companies that have a liquidity deficit (i.e., when the uses of liquidity exceed the sources of liquidity, by our definition). A lack of liquidity could precipitate the default of an otherwise healthy entity, and the use of a liquidity measure can also signal impending financial distress. In our view, a cash-based liquidity signal may indicate distress earlier than revenue or leverage measures, which don't capture a company's cash inflows and outflows, its cash reserves, or its absolute level of debt and debt service costs.

Q8. Do respondents agree that introducing the specialised lending category enhances the risk sensitivity of the standardised approach and its alignment with IRB?

Not necessarily. We believe the proposed uniform 120% risk weighting for specialized lending may overstate risk in some cases. For instance, the proposed risk weighting for the specialized lending category is higher than that for start-ups, which again, in our view, will often miscalibrate the relative risk of these lending categories. Some project financings, for example, can be highly creditworthy and more so than many corporate loans, particularly those to smaller companies and start-ups, given the quality of the cash flows from the underlying project asset and the security and structural protections the project provides to creditors.

Other retail exposures

Q9. Can respondents suggest, and provide evidence on, how to increase the risk sensitivity of the regulatory retail exposures treatment, either by differentiating certain product subcategories for which a specific risk weight may be appropriate; or by suggesting simple risk drivers that could be used to assess the risk of all retail exposures?

We believe that a more granular breakdown of asset subcategories could further improve the framework's risk sensitivity. For example, differentiating between "other" retail and revolving exposures (which we view as typically more risky) and auto loans (which we view as less risky) could improve the risk sensitivity of the standardized approach for retail exposures. To keep it simple, the risk weight for revolving exposures could be an add-on to that for "other" retail exposures, and the risk weight for auto loans could be that for "other" retail, but with a preset discount.

Residential mortgages

Q10. Do respondents agree that LTV and/or DSC ratios (as defined in Annex 1 paragraphs 40 and 41) have sufficient predictive power of loan default and/or loss incurred for exposures secured on residential real estate?

Q11. Do respondents have views about the measurement of the LTV and DSC ratios? (In particular, as regards keeping the value of the property constant as measured at origination in the calculation of the LTV ratio; and not updating the DSC ratio over time.)

Q12. Do respondents have views on whether the use of a fixed threshold for the DSC ratio is an appropriate way for differentiating risks and ensuring comparability across jurisdictions? If not, what reasonably simple alternatives or modifications would respondents propose while maintaining consistent outcomes?

Q13. Do respondents propose any alternative/additional risk drivers for the Committee's consideration in order to improve the risk sensitivity in this approach without unduly increasing complexity?

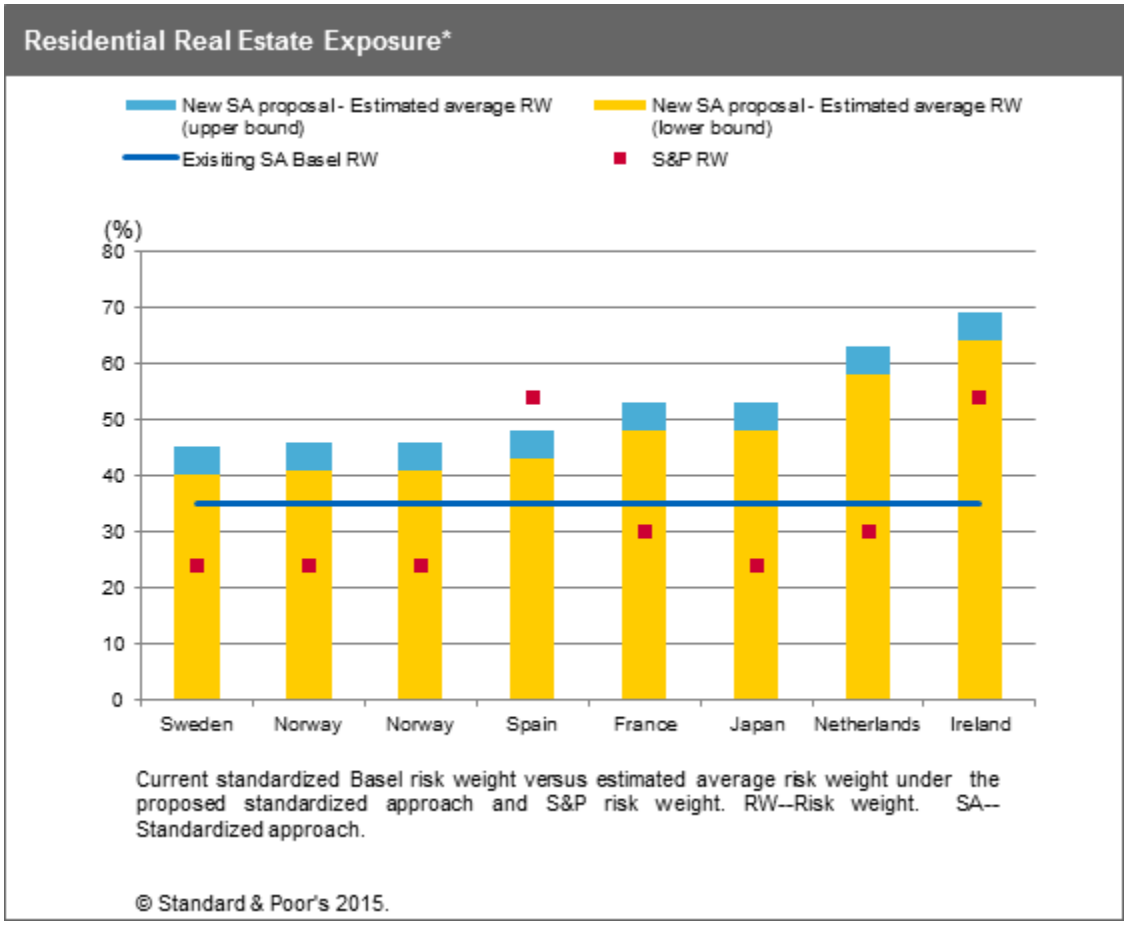
We recognize that the proposal aims for more granular risk weighting than the current flat 35% risk weight for most mortgage exposures. However, the proposed differentiation of mortgage risk weights according to a DSC ratio and the LTV metric may not, in our view, result in the intended greater risk sensitivity. We believe that the proposed calibration is based on a potentially excessive correlation of risk weights with LTV, and that the current proposal doesn't consider other factors that may have a greater influence on the credit risk of mortgage exposures. These include the legislative framework (for instance, the repossession framework, existence of a personal insolvency regime, and ability of creditors to access a borrower's other assets or income streams in the event of default), the nature of the loan (whether owner-occupied, self-certified, or buy-to-let), or the existence of guarantee mechanisms. We believe these factors may greatly outweigh the impact of DSC and LTV on the risk profiles of mortgages and render comparisons between banks and between jurisdictions less meaningful. Some of these factors could be incorporated relatively easily into the framework, in our view. We also question whether differences in the way banks measure these ratios and the frequency with which they are able to update them (e.g., if they rely on property price indexation or borrowers' income updates) will limit their comparability.

We believe that the proposed strong reliance on LTV ratios would lead to significant procyclicality in risk weighting; a 10% house price reduction, for instance, could lead to a roughly 10% increase in capital requirements. In a number of markets, we believe that the correlation between the cost of risk for mortgages and house prices is relatively limited, and its correlation to other changes in the operating environment (such as a rise in unemployment) is much stronger.

We agree that in a number of markets, the mortgage-related regulatory capital requirements banks calculate based on their internal models are too low. We've observed average risk weights for some banks in the low teens or even lower, and believe that internal models sometimes fail to capture tail risk or new types of potential stress events. Under our RAC framework, we apply minimum charges of around 20% for the lowest-risk markets (only Germany), rising to around 50% for markets that we consider to have low to intermediate economic risk according to our Banking Industry Country Risk Assessment methodology, and up to 100% for markets we assess as having the highest economic risk. However, for a number of markets with traditionally high LTV but an otherwise low-risk track record due to other specific features (such as a guarantee scheme, a strong legislative framework and payment culture, etc.), the proposal could lead to a sharp jump in the average risk weight under the SA, in some cases to around 60% from the current 35%

(see chart 5). We believe that, in some cases, the strong correlation with LTV may overstate the risk profile of this asset class.

Chart 5



Currency mismatch

Q16. Do respondents agree that a risk weight add-on should be applied to only retail exposures and exposures secured by residential real estate? What are other options for addressing this risk in a simple manner?

We support this proposal, especially given the numerous recent examples of the greater riskiness of retail exposures denominated in foreign currencies, such as Swiss franc-denominated mortgages in Eastern Europe.

Off-balance-sheet exposures

Q17. Do respondents consider the categories for which a CCF is applied under the standardised approach to be adequately defined?

Q18. Do respondents agree that instruments allocated to each of the CCF categories share a similar probability of being drawn and that the probabilities implied by the CCFs are accurate? Please provide empirical support for your response.

We also support the revised credit conversion factors (CCFs) for off-balance-sheet exposures (which essentially

convert these exposures into equivalent on-balance-sheet exposures), because we believe they'll lead to greater consistency and comparability across banks using different approaches. We acknowledge that the proposed enhancement will improve comparability between the SA and the foundation IRB approach; however, we question the comparability between banks using the SA or foundation IRB and those using the advanced IRB approach with regard to the CCF (of 75% under the proposal) applied to off-balance-sheet commitments, except those that are unconditionally cancellable. We agree with the proposed 10% CCF for commitments that are unconditionally cancellable at any time without prior notice (or that effectively provide automatic cancellation due to deterioration in the borrower's creditworthiness), given that consumer protection laws, risk management capabilities, and reputational risk considerations may constrain banks' ability to cancel such commitments. We believe it might make sense to use the same CCF for the foundation IRB as well.

Past-due loans

Q19. What are respondents' views on the alternative treatments currently envisaged for past-due loans?

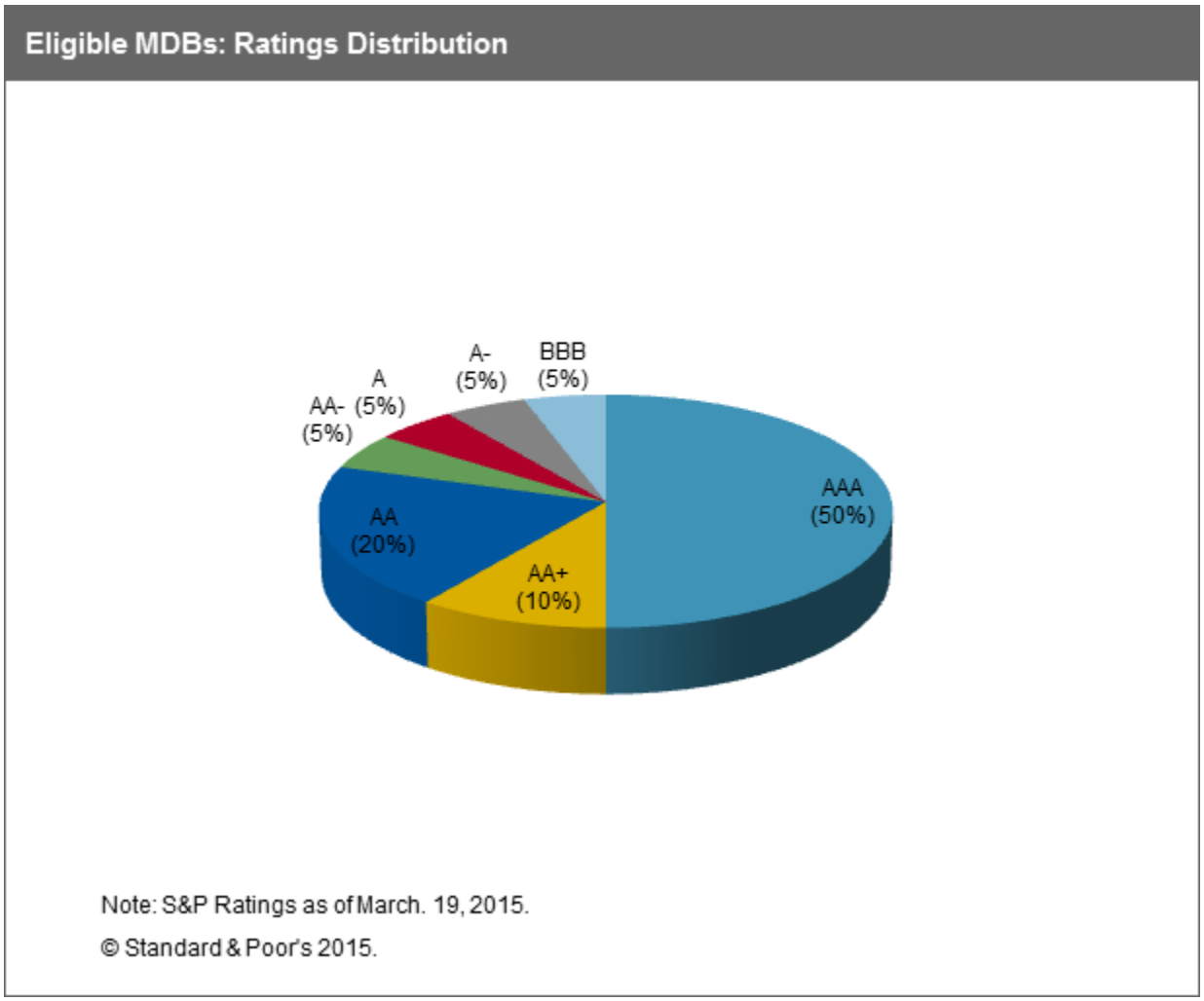
We believe that even if a bank has built up sufficient provisions against past-due loans, the unexpected losses on the net amount of such loans are likely to be higher than those on performing loans. Therefore, in order to adequately capture the risk, we think that an add-on to the risk weights by asset class as a function of the amount of provisions, as the proposal suggests, would be the best option. This is also in line with our approach under our RAC framework.

Exposures to multilateral development banks (MDBs)

Q20. Do respondents agree with the proposed treatment for MDBs?

The treatment to determine qualifying MDBs seems open to significant interpretation, potentially leading to differences across jurisdictions (for example, how much capital is "adequate"?). We also believe that having a fixed list of institutions qualifying for a 0% risk weight may not be optimal, and that all MDBs should instead receive a risk weight based on their credit rating, which would be more risk-sensitive. We note that not all of the MDBs that qualify for a 0% risk weight have 'AAA' ratings from a majority of the large rating agencies.

Chart 6



Moreover, we don't believe there is a significant difference in the creditworthiness of some of the MDBs that qualify for a 0% risk weight (such as Council of Europe Development Bank) and others to which we assign the same rating (such as Eurofima). Finally, we believe that the table determining the risk weights for qualifying MDBs should not be different than that used for the sovereign exposures, though providing more detail would help to fully reflect the granularity of the external rating agencies' rating scales.

Other assets

Q21. What exposures would be classified under "Other assets"? Is a 100% risk weight appropriate?

In our view, the main exposures that would be classified as "other assets" would be:

- Gold and precious metals;
- Property, plant, and equipment;
- Investment property;
- Intercompany transactions not reported elsewhere; and

- Unallocated accrued interest.

While we generally believe that a flat 100% risk weight would be suitable for most of the assets in this bucket, we think that the standardized approach for investment property and for property, plant, and equipment could benefit from more tailored risk weighting that considers the location of the exposure and macroeconomic indicators, such as property price volatility.

Related Criteria And Research

Related criteria

- Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- Bank Capital Methodology And Assumptions, Dec. 6, 2010
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011

Related research

- The Basel III Leverage Ratio Is A Welcome Addition, But Not A Substitute For Risk-Weighted Capital Metrics, Sept. 20, 2013
- The Basel Committee's Revised Leverage Ratio Relaxes Its Calibration Requirements, But Preserves Its Value, Jan. 31, 2014
- Securitization Regulation In Focus: Proposed Revisions To The Basel Framework Could Deter Banks From Investing In European Securitizations, April 3, 2014
- The Basel Committee Proposal For Standardized Regulatory Capital Floors Is A Useful Concept, But Calibration Will Be Key, March 27, 2015
- Default, Transition, and Recovery: Global Corporate Quarterly Default Update And Rating Transitions, Dec. 1, 2014
- Default Study: 2013 Annual Global Financial Institutions Default And Rating Transition Study, Nov. 24, 2014

Under Standard & Poor's policies, only a Rating Committee can determine a Credit Rating Action (including a Credit Rating change, affirmation or withdrawal, Rating Outlook change, or CreditWatch action). This commentary and its subject matter have not been the subject of Rating Committee action and should not be interpreted as a change to, or affirmation of, a Credit Rating or Rating Outlook.

Additional Contact:
Financial Institutions Ratings Europe; FIG_Europe@standardandpoors.com