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The Basel Committee Proposal For Standardized Regulatory Capital Floors Is A Useful Concept, But Calibration Will Be Key

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The Basel Committee Proposal For Standardized Regulatory Capital Floors Is A Useful Concept, But Calibration Will Be Key

(Editor's note: The following is Standard & Poor's Ratings Services' response to the Basel Committee on Banking Supervision's (BCBS) consultative document "Capital floors: the design of a framework based on standardized approaches," issued 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 believes the Basel Committee on Banking Supervision's (BCBS) proposal on standardized regulatory capital floors for banks, released for comment in December 2014, is a step forward. It could provide useful information to investors, reduce model risk, and constitute a helpful tool to address inconsistencies and high variance in regulatory risk-sensitive capital metrics and the sometimes excessively thin regulatory capital requirement that result from banks using internal models. However, in our view, a very strict calibration of these floors would deemphasise internal models in favor of standardized approaches and possibly prompt banks to adjust their risk appetite to maximize returns based on capital requirements that are likely to be generally less risk-sensitive.

Under the current framework, banks have the choice between using a standardized approach (with predetermined risk-weights) or internal models (subject to regulatory approval) to determine regulatory capital requirements. Under the BCBS' latest proposal, banks would continue to have this choice. But we understand that institutions that use internal models would also need to calculate what their capital requirements would be under the standardized approach. And if the internal model-derived capital requirements were to be below a yet-to-be-determined level (or "floor", likely to be expressed as a percentage relative to capital requirements under the standardized approach), this floor would constitute the applicable regulatory capital requirement.

Overview

- We agree that implementing standardized floors for banks that use internal models to derive their capital requirements could support the robustness of the regulatory capital framework.
- Bank model calibrations can sometimes lead to excessively thin regulatory capital requirements for certain exposures, in our view.
- The introduction of new standardized floors could also reduce the gaps between banks using the standardized and internal model-based approaches.
- Given the unavoidable limitations in any single regulatory capital metric and the intrinsic conflict between their risk sensitivity and comparability across institutions, the parallel computation and reporting of standardized and model-derived risk weights would enhance investors' ability to better analyze banks' capital positions.
- However, the calibration of the proposed new standardized floor will be key in avoiding unintended consequences because high floors would reduce the relevance of internal models, and distract regulators and banks from the warranted efforts to continue to improve the consistency and risk-sensitivity of internal models.

The potential rating impact of the proposal will depend on the impact on banks' capitalization strategies, which in themselves will depend on the final calibration of the floors, which is not yet under consultation, as well as the extent of modifications being considered in a separate consultation for the standardized approach (see "The Proposed Revised Basel Standardized Approach For Credit Risk May Add Complexity Without Improving Standards"). Under our criteria, we assess a bank's capitalization using our Risk-Adjusted Capital (RAC) framework instead of regulatory capital measures, but changes in a bank's regulatory capital stance can affect our view of capitalization as well as other aspects of a bank's creditworthiness. Ultimately, any rating impact will depend largely on the impact of the regulatory floors on our view of a bank's capital as shown by its RAC ratio, and any associated impact on its risk appetite or business model. In our view, capital floors could also lead to a clear reduction in regulatory capital ratios for certain banks, for instance in Europe. In the absence of changes in these banks' capital policies, this would reduce their distance to regulatory capital triggers that result in loss absorption (coupon nonpayment, principal write-down, or conversion into common equity) by certain types of hybrid capital instruments--making them relatively riskier at a time when banks are generally aiming to ramp up their capital buffers by issuing more of such subordinated instruments. Under our hybrid capital rating criteria, the rating on instruments with mandatory going-concern, regulatory capital-based triggers decreases as the expected distance to the trigger reduces.

We note that the BCBS' current consultation (Capital floors: the design of a framework based on standardized approaches, published in December 2014) concerns the concept of standardized floors, but not on the possible calibration of such floors. The BCBS expects to publish the final standards around year-end 2015. We believe this consultation has to be viewed as part of a wide range of regulatory initiatives that aim to improve the consistency and comparability of regulatory capital metrics, such as the proposed revisions to the standardized approach, initiatives concerning model validation, or proposals about low-default portfolios. We also believe the parallel disclosure of capital requirements under the standardized approach for banks deriving their capital requirements from internal models--which this proposal implies in our view--will complement the benefits of the recently introduced leverage ratio in terms of identifying outliers (see "The Basel Committee's Revised Leverage Ratio Relaxes Its Calibration Requirements, But Preserves Its Value," published Jan. 31, 2014).

Standardized Floors Could Enhance The Comparability Of Regulatory Capital Metrics

We believe the implementation of standardized capital floors could benefit the overall regulatory capital framework in various ways. First, we agree that banks' internal models can lead in some cases to excessively thin regulatory capital requirements for certain exposures. For instance, the internal models several European banks use derive average risk weights for mortgage exposures that are in the low-teens, sometimes even less. While the good asset quality track record generally underpins these low risk weights, we believe that such models may underestimate potential tail risks and unforeseen stress events. Under our RAC framework, our minimum risk weights for mortgages are considerably higher, at 19% (for Germany, the country we assess as having the lowest economic risk) and up to 30% or more for many markets.

In addition, various studies (including those the Basel Committee carries out as part of its regulatory consistency

assessment program) have demonstrated material variability in regulatory capital requirements for similar exposures between banks and between jurisdictions, whether in the trading or banking books. This highlights to some extent potential inconsistencies not only between banks' model parameters but also between supervisory practices concerning model validation. We believe the concept of floors could at least partly offset some limitations of internal models by reducing the risk of excessively low capital buffers set against specific exposures and of very large inconsistencies between the regulatory capital different banks set aside for similar exposures, depending on their final calibration.

Also, we believe standardized floors could help reduce the gap between standardized and internal ratings-based capital requirements and therefore make regulatory capital ratios more comparable across banks and jurisdictions and less dependent on the specific approach banks follow.

Final Calibration Should Not Distract Banks Or Regulators From Warranted Efforts To Improve Internal Models

We also note that the BCBS' standardized approach on which the floors would be based is subject to a potentially material overhaul (see "The Proposed Revised Basel Standardized Approach For Credit Risk May Add Complexity Without Improving Standards"). The appropriateness of the as-yet-undetermined calibration will ultimately depend to a large extent on the magnitude of any changes the BCBS might decide on for the standardized approach.

While standardized floors could reduce model risk to some extent, we believe the calibration the BCBS uses should be mindful not to distract banks (and their supervisors) from efforts to develop or improve internal models. We believe internal models remain better placed to capture the particularities in the risk profile of a bank's exposure – for instance in terms of underwriting and in understanding the key determinants of a counterparty's risk profile, the quality of the collateral provided, the risk profile of the counterparty's sector, or impact of the legislative framework in place. Standardized risk weights are not designed to capture these nuances, although they aid comparability across banks. We believe whenever possible, banks should keep striving to develop reliable internal models, and regulators should aim to provide a more consistent validation of these models across banks and across jurisdictions.

If the BCBS sets floors too high, we believe the framework it's considering could have unintended consequences. Internal models would lose any influence in determining regulatory capital requirements, with standardized risk weights becoming in practice the determining factor for the capital requirements of all banks—unless internal models derive higher requirements. If that were the case, we believe some banks might adjust their risk appetite to optimize returns—unless they can materially adjust pricing—and make lending decisions partly based on less risk-sensitive capital requirements. In turn, this could magnify the impact of unavoidable limitations in the calibration of standardized risk weights.

However, we believe the parallel disclosure of standardized risk-weighted assets which this proposal seems to imply could be very useful for investors. In our view, such disclosure, along with more consistent and systematic disclosure of asset quality indicators per asset class and main geographies (see "Standard & Poor's Supports The Basel Committee's Proposals To Enhance Banks' Pillar 3 Disclosures," published on Oct. 9, 2014) would allow market

participants to back-test and challenge model-derived regulatory capital requirements, which would in turn foster market discipline. Large differentials between regulatory capital ratios using the standardized approach and a bank's internal models could at the very least lead a bank to be required to explain to the market why it believes it's less exposed to certain risks than peers.

The BCBS proposal considers two main options for calibration: either on total aggregate standardized risk-weighted assets (RWA) or split by risk type (such as credit risk, market risk, and operational risk). The proposal recognizes that the second approach would not allow for offsetting between risk types. We believe the second option could therefore have a greater impact on banks with less diversified business models or on those that use internal models for just one risk type. Even if the final calibration were to opt for floors based on aggregate standardized RWA, we believe investors would benefit from the disclosure of the standardized RWAs by risk category and ideally by exposure type (eg, mortgages, other retail, corporates, etc.). A granular asset class breakdown would allow investors to identify the areas which are driving the differences between internal models and standardized risk-weights. Combined with the systematic disclosure of a few risk indicators (eg, nonperforming loans, charge offs, or provisions broken down per asset class) according to the same segmentation, it would in our view enable investors to challenge or understand better the outcomes of a bank's internal models. In our view, banks' summary explanations of the main reasons for gaps between model-derived and standardized risk weights could foster greater market confidence in risk-sensitive regulatory capital metrics.

Any Potential Rating Impact Depends On Banks' Strategic Responses To The Yet-To-Be-Determined Calibration

Until we get more clarity on the future actual calibration of the standardized approach—and on the magnitude of changes yet to affect the existing standardized approach—we can't determine the extent to which the proposed framework could affect our bank ratings. However, the use of floors would likely increase regulatory capital requirements for many banks using internal models, although we can't form a view at this stage about the scale of the potential increase. As the future actual calibration becomes clearer, the potential impact on our bank ratings will depend on three main aspects, in our view:

- Whether the framework would lead to further capital accumulation by certain institutions, which could lead to increases in our RAC forecasts. If material enough, such increases could lead us to improve our assessment of a bank's capital and earnings under our bank rating methodology. We would also consider whether the BCBS' consultation or quantitative study bring to light material new information regarding the risk profile of certain asset classes that banks have not historically disclosed;
- Whether this could encourage certain banks to increase their risk appetite to adjust their returns to revised regulatory capital requirements—which could over time lead us to weaken our assessment of a bank's risk position; or, to a lesser extent,
- Whether certain business models could prove vulnerable due to the revision in regulatory capital requirements (for instance, if some activities were pushed to the "shadow banking" system)—which could lead us to lower our assessment of an entity's business position.

We believe the potential impact of this framework will become clearer once the BCBS releases its related quantitative

impact study, planned for next year.

The Impact On Regulatory Capital Ratios Will Likely Vary Across Regions

Although the overall impact of the floors will depend on the calibration—not only in terms of threshold but also general approach (aggregate RWA versus RWA by risk type)—and the ultimate changes that will affect the standardized approach, we believe possible increases in RWA would potentially vary notably between banks and regions. Regions where the majority of banks—including larger institutions—primarily use the standardized approach, for instance, in Latin America, Middle East, and Asia-Pacific excluding Japan and Australia, will naturally see a smaller (or no) impact from the introduction of floors.

In the U.S., we believe the Collins Amendment to the Dodd-Frank Act—whereby regulatory capital requirements for the larger entities under Basel III are determined by the higher of either the standardized or model-derived approaches—means the floors would be unlikely to have any meaningful impact.

Elsewhere, the potential increase in RWA will be the greatest where internal models lead banks to factor in much lower risk-weights for certain exposures than under the standardized approach (including its upcoming amendments). We believe banks with large mortgage portfolios benefiting from a track record of low credit risk (supporting low model-derived risk weights) and with relatively high loan-to-value ratios could be particularly affected. We believe these institutions are mostly located in Europe (eg. Netherlands, Denmark, and Sweden). Some countries (such as Sweden and Australia) have already introduced floors of different natures to reduce the risk of excessively thin regulatory capital requirements for mortgage exposures.

The Proposal Could Reduce Some Need For Pillar 2 Add-Ons But May Increase The Perceived Risk Profile Of Certain Bank Hybrids

Regulators in some jurisdictions have been increasingly using supplementary Pillar 2 requirements to capture risks they believe are not adequately reflected in Pillar 1 regulatory capital ratios. Pillar 1 refers to minimum capital requirements based on credit, market and operational risks—currently calculated either under the standardized approach or based on internal models. Pillar 2 requirements allow a bank and its regulator to take into consideration risk factors that the pillar 1 requirements don't capture (such as concentration, pension, liquidity, or reputational risks for instance). We believe the introduction of standardized floors could in some cases reduce the size of required Pillar 2 add-ons because higher Pillar 1 requirements could better capture certain risks. For instance, in countries such as Sweden that have included mortgage risk-weight floors as part of Pillar 2 requirements, we believe the BCBS proposal could lead to these requirements being captured in Pillar 1 capital requirements instead. We note that the use and transparency of Pillar 2 requirements vary considerably between jurisdictions. As a result, the proposed floors could improve the transparency and comparability of banks' minimum regulatory capital requirements for investors.

However, many bank hybrid capital instruments include references to regulatory capital triggers. By potentially lowering regulatory capital ratios, even if total requirements (including Pillar 2) don't change materially, the introduction of standardized floors could reduce the distance to trigger for certain hybrid instruments, particularly

those with high, going-concern, triggers. In the absence of actions by banks to widen these distances, this could therefore create some uncertainty for investors at a time when many banks are aiming to increase issuance of such instruments to boost their loss-absorbing buffers. Under our hybrid capital rating methodology, we lower the rating on hybrids instruments with mandatory going-concern, regulatory capital-based triggers as the expected gap to the regulatory trigger decreases. In this respect, we welcome the BCBS' publicly stated intention to publish the final rule for standardized capital floors, including its calibration and implementation arrangements, around the end of 2015.

Related Criteria And Research

Related criteria

- Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banks: Bank Capital Methodology And Assumptions, Dec. 6, 2010

Related research

- The Proposed Revised Basel Standardized Approach For Credit Risk May Add Complexity Without Improving Standards, March 27, 2015
- Standard & Poor's Supports The Basel Committee's Proposals To Enhance Banks' Pillar 3 Disclosures, Oct. 9, 2014
- The Basel Committee's Revised Leverage Ratio Relaxes Its Calibration Requirements, But Preserves Its Value, Jan. 31, 2014
- The Basel III Leverage Ratio Is A Welcome Addition, But Not A Substitute For Risk-Weighted Capital Metrics, Sept. 20, 2013

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