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Basel's Revision Of The Standardized Approach To Credit Risk: One Step Closer To Squaring The Circle?

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Executive Summary

(Editor's note: The following is Standard & Poor's Ratings Services' response to the Basel Committee on Banking Supervision's second consultative document "Revision to the Standardised Approach for credit risk," issued on Dec. 10, 2015. 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) latest proposal to revise the standardized approach (SA) for assessing banks' credit risk is an improvement on the initial version (see "The Proposed Revised Basel Standardized Approach For Credit Risk May Add Complexity Without Improving Standards," published on March 27, 2015). In our opinion, these revisions, which the BCBS released for comments in December 2015, will better address the conundrum of risk-sensitivity and simplicity in standardized capital requirements. We also note some improvements in the granularity of capital requirements compared with the existing approach, although we believe it could still benefit from a few additional enhancements.

The overall impact on banks' creditworthiness will in our view be limited; but it will also depend on other consultations currently under way, such as the proposed introduction of standardized floors for banks using internal models. A very strict calibration of these floors could, in our view, de-emphasize internal models in favor of standardized approaches. We also note that the capital treatment of exposures to sovereigns, central banks, and public sector entities is not in scope of this consultation. The proposal may affect some challenger banks more, in our view, given that they are often more likely to use the SA to calculate capital requirements.

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. 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.

Overview

- We believe the BCBS' latest proposal should improve the risk-sensitivity of the proposed framework, though it could benefit from a few additional enhancements.
- We see value in the conditions set around the use of external ratings (for example, due diligence by banks). However, we consider that the recommendation to use bank ratings that exclude government support adds complexity to the framework, while likely reducing its risk-sensitivity.
- The overall impact on banks' creditworthiness will be limited in our view; though this will also depend on other consultations currently under way.
- We expect, for instance, that the regulatory risk-weighted assets of banks with large mortgage portfolios with relatively high loan-to-value ratios or a high proportion of buy-to-let mortgages 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).
- The exclusive focus on LTVs for mortgages could lead to relativities in capital requirements that are not consistent with their relative riskiness.
- Depending on the calibration of the proposed introduction of standardized floors, the revised SA approach could sideline the IRB approach--especially in light of its perceived greater risk-sensitivity compared to the current approach and the development of other regulatory capital assessment tools, such as stress testing--similar to what we've witnessed in the U.S. with the Collins Amendment.

Some of the main changes in the revised consultation reside around the proposed continued use--under certain conditions--of external ratings for corporate and bank exposures and for the purpose of evaluating the haircuts on collateral under the SA's credit risk mitigation framework. We fully support efforts to reduce mechanistic reliance on credit ratings, but we also understand the need for comparable credit analysis. We support this revised consultation efforts to strike an appropriate balance, and believe that the conditioned use of credit ratings maybe a viable approach for certain regulators.

Also, we note the proposal for greater differentiation and segmentation in the capital requirements for mortgages and real estate lending, depending, for instance, on the nature of the collateral and the loan-to-value (LTV). Compared to the existing approach, risk-weights assigned to standard bank and corporate exposures tend to be generally similar. But the proposals introduce a greater segmentation (e.g., the distinction between short- and long-term exposures and higher requirements for subordinated and equity exposures), an improved alignment of certain definitions with the BCBS' existing internal ratings-based approaches (e.g., on defaulted exposures), and the elimination of the use of certain national discretions (e.g., the currently permissible use of sovereign ratings to risk-weight bank exposures).

We note that some of the calibrations may still be adjusted, as the BCBS is conducting a quantitative impact study this year, which will determine the final calibrations.

We see value in conditions set around the use of external ratings, such as the due diligence requirement, to avoid banks' mechanistic reliance on them. However, the recommendation to use bank ratings that exclude government support would, in our view, add complexity to the framework, while likely reducing its risk-sensitivity.

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Further segmenting retail portfolios could still improve risk sensitivity

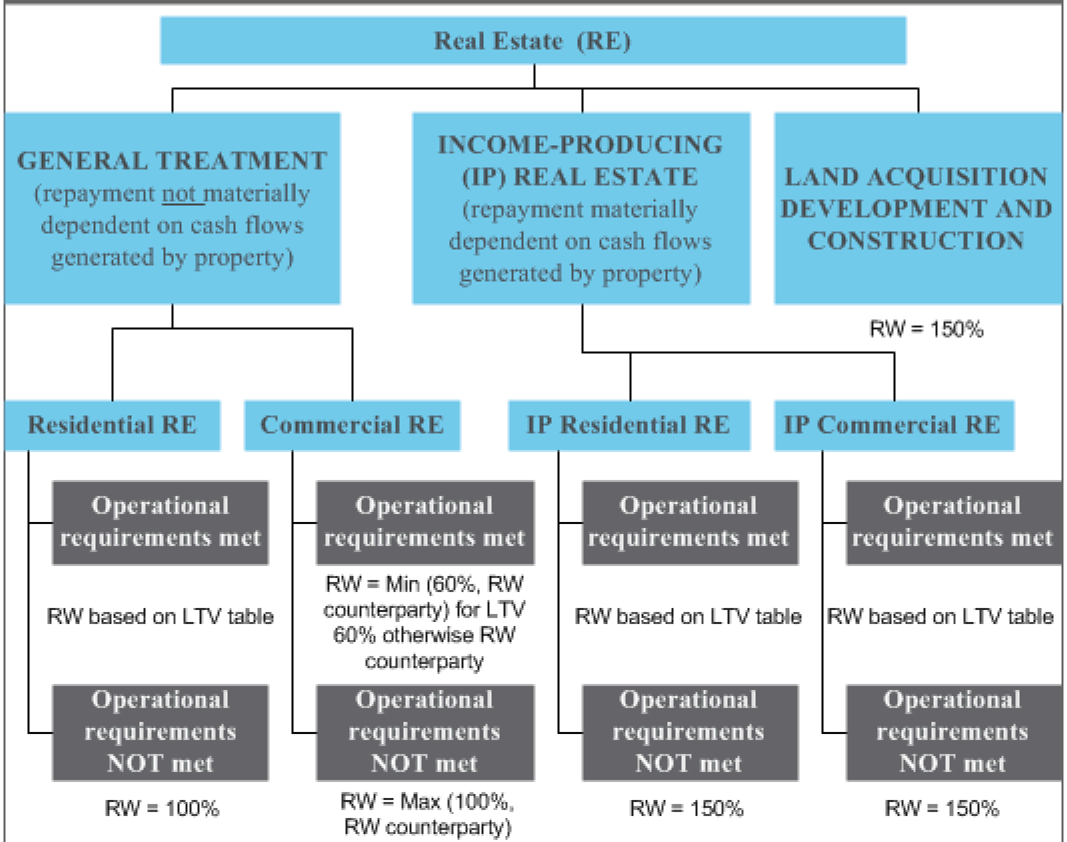
The proposed general framework--differentiating retail mortgages from non-real estate retail exposures (in turn segmented between "regulatory retail exposures" and "other retail exposures") is appropriate, in our view. That said, for non-mortgage exposures, we believe the proposal could go further with a more granular breakdown of retail asset classes, such as auto loans--which we view as less risky than average retail exposures--and revolving exposures--which we view as more risky.

The proposal for non-mortgage retail exposures remains largely unchanged from the original proposal. The retail category will be broken down into "regulatory retail"--for exposures which meet a set of criteria (including around size of the exposure)--and "other retail". "Regulatory retail" and "other retail" exposures will receive risk weights of 75% and 100%, respectively. Exposures to small and midsize enterprises (SMEs) can be included in these segments. We note that the definition of SMEs is aligned with that used for other regulatory approaches (consolidated turnover of less than €50 million).

The proposed revision to real estate exposure classes is a step forward

The revisions around the segmentation of real estate exposures are an improvement on the original proposals, in our view. As such, we agree with the general relativity of risk weights assigned to these segments. Under the latest proposals, real estate exposures would be split into three asset classes (see chart 1).

Chart 1
Summary Of The Proposal For Real Estate Exposures



RW--Risk weight. LTV--Loan-to-value.

However, the emphasis on a LTV metric, especially for owner-occupied mortgages, may not necessarily lead to the intended greater risk sensitivity. This has been accentuated since the original proposal given the removal of the reference to a debt service metric. 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 existence of guarantee mechanisms, or variations in the unemployment rate. These factors could, in our view, significantly outweigh LTV metrics and make comparisons between banks and jurisdiction less meaningful. At the same time, we recognize that trying to consider a greater number of factors may hinder the framework's objective of simplicity.

For a number of markets with traditionally high LTVs, but an otherwise low-risk track record due to other specific features (such as guarantee schemes, a strong legislative framework, and payment culture), the proposal for mortgage exposures could, in our view, lead to a marked increase in the standardized risk weight and may overstate the risk taken compared with other markets.

Under the latest proposal, the risk charge for buy-to-let mortgages would be different from that for owner-occupied mortgages—typically double that level. While we agree that buy-to-let mortgages are typically riskier than owner-occupied mortgages, we question the relativity for instance with unsecured SME exposures, which may attract a broadly similar or lower risk weight despite often having a higher risk profile.

We note the BCBS' proposal to keep property prices constant with the level at origination in the LTV calculation. However, the proposal provides local regulators with the flexibility to revise the value downwards, for instance in case of a general price decline. We believe that the proposal could lead to a significant pro-cyclical effect (a 10% property price decrease could lead to an increase by around 10% in the capital requirement), or inconsistent approaches between regulators in their use of flexibility to revise property prices.

Proposed CCFs for off-balance-sheet exposures will improve comparability and risk-sensitivity

We support the revised credit conversion factors (CCFs) for off-balance-sheet exposures because we think they will lead to greater consistency and comparability between regulatory capital ratios.

Furthermore, we believe that the proposed CCFs will adequately capture risk, given the consumer protection law that may be in place in a given country, and reputational risks.

We believe the CCFs could also be applied in the Foundation IRB approach. We note that the BCBS now suggests a 10%-20% CCF for retail commitments only (such as credit cards), compared with the flat 10% in the original proposal and from the current 0%. While we agree with the revised proposal, we consider that this could have a significant impact on some banks (such as credit card retailers or consumer finance companies).

Corporate exposures could still benefit from adjustments for greater risk sensitivity

We consider that SMEs (defined by the BCBS as "corporate exposures where the reported sales for the consolidated group of which the firm is a part is less than €50 million") will often have higher default risk than more established companies with larger revenue bases. Those more established companies often benefit from a larger organizational infrastructure, larger market share, and a greater revenue and earnings base. As such, we believe the proposed risk weightings will not, in some cases, sufficiently account for the relatively lower risk of established companies relative to SMEs. For example, in jurisdictions that do not use external ratings for regulatory purposes, the BCBS proposes that a base risk weight of 85% be used for SMEs, whereas all other corporate exposures would be weighted at 100% except for exposures to entities that banks assess as being investment grade, which would be weighted at 75% according to the proposal.

In addition, the proposed 85% risk weighting of unrated exposure to SMEs in jurisdictions that use external ratings for regulatory purposes is lower than the 100% risk weighting proposed for all other unrated exposure (i.e. for non-SME exposures) in those jurisdictions. It is also a lower risk weighting than, for example, the 100% risk weight proposed for corporate exposures in the 'BBB-' to 'BBB+' rating category--an investment-grade rating category (see table 2). Again, we believe these proposed risk weightings will not, in some cases, sufficiently account for the relatively lower risk of established companies relative to SMEs. Finally, we note that the same 150% risk weighting would be applied to both nonsubordinated and subordinated exposures to an entity rated below 'BB-' in jurisdictions that use external ratings for regulatory purposes. In other words, there would be no risk adjustment to reflect the greater incremental risk of a subordinated debt exposure for such entities.

We further believe that the risk calibration of the BCBS' proposed definition of "investment grade" corporates for the purposes of assigning risk weights in jurisdictions that do not use external ratings for regulatory purposes would be enhanced if the characteristics of an "investment grade" company included measures of the relative risk of the entity's business model (its business risk) and quantitative measures of its relative financial risk (its financial 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. A corporate entity's business risk determines how stable its profitability is. Companies with strong competitive positions that operate in stable, transparently regulated industries in jurisdictions with low country risk have significantly lower risk of default than, for example, companies 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. 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 financial commitments. The quantum of cash flow generation, current and future, in relation to cash obligations is, in our view, often the best indicator of a company's financial risk.

We continue to believe that the risk weighting of subordinated debt would better reflect relative risk if it were to be anchored to the overall 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. We believe that the proposed non-risk-adjusted standard 150% risk weighting for all subordinated corporate debt will, in some cases, inaccurately calibrate the relative risk of subordinated debt depending on the underlying credit quality of the subordinated debt issuer. 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. In our view, a subordinated lender to a strong corporate entity faces significantly lower default risk than a senior lender to a weak corporate entity, and the proposed risk weightings don't reflect this.

Box 1: Summary Of The Proposal For Corporate Exposures

- In jurisdictions that allow the use of ratings for regulatory purposes, external credit ratings would be the starting point to determine risk weights for rated exposures. As in the case of exposures to banks, due diligence could result in a higher risk weight than that determined by ratings. The criteria for eligibility of guarantors and financial collateral would also be primarily based on external ratings, as in the current approach.
- In jurisdictions that do not allow the use of ratings for regulatory purposes, a lower risk weight of 75% would apply to certain corporates that banks deem to be investment grade. Other exposures would receive a 100% risk weight. Investment grade entities and debt securities issued by them, would be allowed as eligible credit risk mitigants. Where issue-specific external ratings are either not available or not allowed for regulatory purposes in a jurisdiction, the BCBS proposes a flat risk weight of 120% for object and commodity finance exposures (irrespective of the counterparty's risk weight); a 150% risk weight for the pre-operational phase of project finance; and 100% risk weight in the operational phase.

Table 1

Risk Weights For Corporate Exposures

External rating of counterparty	AAA to AA–	A+ to A–	BBB+ to B–	Below B–	Unrated
"Base" risk weight	20%	50%	100%	150%	100%
Small and midsize enterprises	85%	85%	85%	85%	85%

Comparability between U.S. and non-U.S. banks may remain difficult. The proposal allows the use of external ratings to assess credit risk, which is prohibited in the U.S. under Dodd-Frank. This could lead to significantly different risk assessments; for example, the lowest risk weighting for investment-grade corporate counterparties using external credit ratings is 20%, compared to 75% using internal credit assessments.

The general framework for bank exposures is simpler and better designed than under the previous proposal

We consider the proposed revisions around the treatment of bank exposures an improvement on the original proposals. The latest proposals allow the use of external ratings--under certain conditions--to derive the risk weights assigned to bank counterparties (see Box 2). In jurisdictions that don't allow the use of external ratings, or for unrated exposures, banks are required to classify exposures in three different risk buckets, which will determine the risk-weights assigned to these exposures.

We believe a bank's creditworthiness depends on a range of factors that go well beyond capital adequacy and asset quality. To determine risk weights, the BCBS originally proposed the use of common equity Tier 1 (CET1) or Tier 1 ratios of a bank counterparty, combined with a net nonperforming asset (NPA) ratio. In seeking to reduce the framework's reliance on external credit ratings, the initial proposal increased its reliance on metrics that are not always publicly available in a timely manner and could be measured inconsistently. In our view, the emphasis on these two metrics omitted a number of significant drivers of a bank's risk profile, such as, among others, 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. 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.

However, we generally agree with the conditions set around the use of external ratings, to reduce the risk of banks' mechanistic reliance on external ratings. The proposal conditions the use of external ratings on a due-diligence by the bank that the external ratings "appropriately and conservatively" reflect the credit risk of the exposure, even if the details of the minimum standards of due-diligence remain unclear.

Removing government support from bank ratings could weaken the framework

We see the recommendation to use bank ratings that exclude government support as adding complexity to the framework, while likely reducing its risk-sensitivity.

First, we note that other ongoing regulatory developments, such as the creation of effective resolution regimes, have reduced the implicit extraordinary support potentially available to banks in these regions. We have consequently removed the related rating uplift from a number of bank ratings in the U.S. and in Europe (see "Most European Bank Ratings Affirmed Following Government Support And ALAC Review" and "U.S. Global Systemically Important Bank Holding Companies Downgraded Based On Uncertain Likelihood Of Government Support," published on Dec. 2, 2015). Over the past 12 months, this has led us to remove the government support uplift from the ratings on 40 of the 100 largest banks we rate--by nature a sample of some of the most systemic banks.

Simply removing the uplift for government support would potentially reduce the risk-sensitivity of the framework. In jurisdictions where we continue to factor some government support in the ratings of systemic or government-related banks, we believe that this uplift remains a relevant element of the credit risk profile of these entities, particularly in certain systems in Asia-Pacific or in the Middle East.

Also, we believe that trying to remove the government support uplift would only affect the potential risk-weight of a very small minority of bank exposures. In most of the cases where we include support uplift in bank ratings, we typically limit this to one or two notches. We note that the proposed framework incorporates a limited amount of granularity of risk-weights compared with ratings. For instance, the "base" risk-weight remains the same for bank exposures with a rating between 'BBB-' and 'A+'--that is, across two rating categories (see table 3).

Finally, we believe that trying to remove government support from bank ratings would lead to considerable practical challenges. First, government support is only one of several forms of support we may factor into bank ratings (along with group support or additional loss-absorbing capacity [ALAC] support). However, under our methodology, support uplift is not additive, and therefore removing the uplift for government support for a bank may be misleading as the bank may have been eligible for uplift from another source of support under our methodology. As such, we don't disclose what would constitute a bank rating without government support.

In addition, our stand-alone assessment of banks may include some ongoing government support received or committed by the authorities to a bank. In a resolution process, short-term support--possibly liquidity support--may be a critical aspect of a bank's credit risk profile, contributing to reducing the volatility in the latter. Finally, the proposal still allows for support to be factored in for government-owned banks. We note that a number of banks may fulfill a public-policy role without being owned by a government, or owners may be public authorities without being the government itself. Allowing such exceptions may require specific--and potentially complex—definitions, or lead to some inconsistencies in interpretations globally.

Box 2: Summary Of The Proposal For Bank Exposures

External Credit Risk Assessment Approach (ECRA):

- For rated exposures of banks incorporated in jurisdictions that allow the use of external ratings for regulatory purposes, external credit ratings would be the starting point to determine risk weights for rated exposures.
- As with the proposal for corporate exposure, to reduce the risk of mechanistic reliance on ratings, a bank using this approach would be required to perform due diligence to ensure that the external credit rating appropriately reflects the credit risk of the exposure. If the due diligence led to an assessment that is worse than the external rating, the bank would apply a higher risk weight for the exposure.
- As in the initial consultation, interbank exposures under three months would receive a lower risk weight.
- Banks' external ratings used for regulatory capital purposes should exclude government support.

Standardised Credit Risk Assessment Approach (SCRA):

Elsewhere, and for unrated exposures, banks are required to classify exposures in three different buckets:

- Grade A: Counterparties that have adequate capacity to meet their financial commitments (including repayments of principal and interest) in a timely manner, for the projected life of the assets or exposures, and irrespective of economic cycles or business conditions. A counterparty bank classified into Grade A must exceed the published minimum regulatory requirements and buffers (e.g. systemic, capital conservation, and countercyclical capital buffers).
- Grade B: Counterparties that are subject to substantial credit risk, with repayment capacities dependent on stable or favorable economic or business conditions; or where a counterparty does not meet one or more of the applicable published regulatory buffers.
- Grade C: Counterparties that have material default risks and limited margins of safety. For these counterparties, adverse business, financial, or economic conditions are very likely to lead, or have led, to an inability to meet its financial commitments. At a minimum, a Grade C risk weight would apply where the auditor has issued a modified adverse audit opinion or has expressed doubts that the counterparty will be a going concern in its financial statements or audited reports; or where the bank counterparty has breached any of the published and binding minimum regulatory requirements.

Table 2

Risk Weights For Bank Exposure Under The ECRA--Before Due Diligence

External counterparty rating	AAA to AA-	A+ to BBB-	BB+ to B-	Below B-
'Base" risk weight (same as currently)	20%	50%	100%	150%
Risk weight for short-term exposures	20%	20%	50%	150%

Table 3

Risk Weights For Bank Exposures Under The SCRA

Counterparty credit risk assessment	Grade A	Grade B	Grade C
'Base" risk weight	50%	100%	150%
Risk weight for short-term exposures	20%	50%	150%

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The credit impact on banks should be limited

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. 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.

The impact on regulatory risk-weighted assets (RWAs) will likely differ greatly among banks and jurisdictions, even though we estimate that the latest proposals have been calibrated to avoid a systematic increase in requirements compared to the existing approach. 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 or a material proportion of buy-to-let mortgages. "Challenger" banks in certain European countries for instance could feel a strong impact, in our view.

However, the impact will not be limited to banks using the SA. As a result of the parallel BCBS proposals on standardized capital floors for banks using IRB approaches, depending on the final calibration of these floors, the SA revision could also indirectly (and perhaps significantly) affect banks using IRB approaches (see "The Basel Committee Proposal For Standardized Regulatory Capital Floors Is A Useful Concept, But Calibration Will Be Key," published March 27, 2015). 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 risk-adjusted capital framework (RACF) approach. We note that a number of countries (e.g. Sweden and Norway) have introduced risk-weight floors on mortgages in the form of Pillar 2 requirements, which would likely reduce the impact of standardized floors on their overall capital requirements.

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 to 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, reflect some of the Pillar 2 add-ons some regulators currently apply.

We believe the BCBS' quantitative impact study will be key to understanding the implications of the proposal, and its possible limitations. We also believe that better and more standardized disclosures will be key to improving market 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.

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 Committee Proposal For Standardized Regulatory Capital Floors Is A Useful Concept, But Calibration Will Be Key, March 27, 2015
- The Proposed Revised Basel Standardized Approach For Credit Risk May Add Complexity Without Improving Standards, March 27, 2015

We have determined, based solely on the developments described herein, that no rating actions are currently warranted. Only a rating committee may determine a rating action and, as these developments were not viewed as material to the ratings, neither they nor this report were reviewed by a rating committee.

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