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Basel Committee on Banking Supervision Third Consultation Paper

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Standard & Poor's Response

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Executive Summary

Standard & Poor’s Ratings Services supports the Basel Committee on Bank Supervision’s (the committee) efforts to improve bank risk sensitivity, and encourage banks to improve their risk assessment and measurement. Standard & Poor’s continues to be concerned about calibration issues, where the capital requirement does not adequately capture, or is insufficient or in some cases is excessive, for the risk being assessed. These could create a false confidence from the statistical quantification of risk and have the potential for market distortions.

It is Standard & Poor’s view that banks that substantially reduce their capital on the basis of The New Basel Capital Accord (the accord) as a result of metrics with which Standard & Poor’s does not agree, could be downgraded.

The calculation of risk weighting for both commercial and retail lending will under-count the level of capital required for higher risk commercial loans and for qualifying revolving retail loans as well as all other types of retail loans. Standard & Poor’s believes that capital should be viewed as supporting an ongoing lending operation capable not only of absorbing unexpected losses through the economic and credit cycle, but of providing a cushion to permit continued operations.

Standard & Poor’s supports an open and transparent process to designate credit rating agencies for regulatory purposes, including the determination of external credit assessment institutions (ECAIs) for the purpose of the accord. The transparency of any designation process reduces regulatory barriers to entry and ensures that the markets remain the ultimate judge of the ratings process.

The accord is intended to be neutral with respect to securitization, and Standard & Poor’s supports that intent. It is difficult, however, to reconcile the disincentives to securitization currently embedded in the accord with the accommodation made in regard to other sectors, notably mortgage and retail credit. Standard & Poor’s concerns about securitization include the possible impact of the effective discouragement of securitization on bank funding, financial intermediation, availability of consumer credit and the specific coherence in treatment for the credit risk of assets on an unsecuritized basis relative to the treatment of these same assets on a securitized basis.

Standard & Poor’s is a strong proponent of assessing operational risk as part of determining the overall creditworthiness of a financial institution. However, Standard & Poor’s remains cautious about over-reliance on any model as a means of definitively measuring operational risk.

Implementation must ensure that supervisory standards are consistent worldwide, a significant challenge. Potential variability in the forward looking aspects, or stress testing, under the accord that would enable banks and supervisors to anticipate changes in the banking market or a bank’s risk profile is of concern to Standard & Poor’s. The absence of any such mechanism heightens the need for a substantial capital cushion beyond that required for already identified credit and operational risk.

Enhanced disclosure is consistent with greater regulatory reliance on the bank's internal risk measurement processes as a determinant of regulatory capital requirements. The increased reporting will be incrementally helpful to major institutions, and is most helpful to banks where capital markets related risk transfer activity is greatest. This increases the information available for use when conducting risk analysis.

Introduction

Standard & Poor’s Ratings Services supports the Basel Committee on Bank Supervision’s (the committee) efforts to improve banks’ sensitivity to risk and encourage banks to improve their risk assessment and measurement. We agree that increased complexity in financial intermediation requires stronger supervision, and enhanced disclosure. It is however, important to recognize that changes in the availability of credit, both wholesale and retail, caused by incentives created by The New Basel Capital Accord (the accord) could have far-reaching effects on bank funding, continued development of international capital markets, and also on macroeconomic growth.
Standard & Poor’s continues to be concerned about some calibration issues, particularly to the extent they create the potentially false confidence that can come from the statistical quantification of risk, which by definition cannot measure unexpected risk, nor be forward looking in the identification of risks from new products or changes in market conditions that have not been observed previously.[1]

Standard & Poor’s comments on the Third Consultation Paper (CP3) concentrate on those aspects of the paper that are new, and particularly on asset securitization. As several of the concerns mentioned in Standard & Poor’s previous comments have not yet been taken into account, these have been reiterated in Appendix 1 of this document.

Comments Specific to the CP3 Dated April 2003

Pillar 1 — Minimum Capital Requirements

It is Standard & Poor’s view that banks that substantially reduce their capital on the basis of the accord, as a result of metrics with which Standard & Poor's does not agree, could be downgraded.
Standard & Poor’s is especially skeptical of the results of the most recent quantitative impact study (QIS3), which showed that participating banks, as measured by probability of default (PD), would regard only 25% of Group One corporate exposure, and 17% of Group Two corporate exposure, as speculative[2]. This seems low. Standard & Poor’s own view, based on its bank rating experience and confirmed by its work on collateralized loan obligations (CLOs), is that the *average* credit quality of many banks’ portfolios tends to be at the high end of speculative grade. The difference between these two views demonstrates the potential range of views on appropriate levels of capitalization. This supports arguments for a capital cushion above and beyond the quantified capital for a given credit risk in order to recognize that there is no absolute measure of credit risk.

[1] The dotcom bubble is the most obvious example. Market exuberance on mobile telephony would be another.

[2] Where speculative grade is defined as a PD of 0.8% or better

Risk Weights — The Standardized Method and the Internal Ratings Based Methods

The calculation of risk weights for both commercial and retail lending will under-count the level of capital required for the higher risk commercial loans, and for qualifying revolving retail loans, as well as all other types of retail loans. The correlation factor incorporated into the calculations serves to reduce the incremental capital required for each additional unit of risk, so that the amount of capital for higher risk credits does not rise commensurately with PDs. Standard & Poor's does not agree that higher risk corporate borrowers are less correlated to the systemic factors affecting the entire loan portfolio. Standard & Poor's research indicates that the reverse is true: higher risk credits are more correlated to the economy than lower risk ones. In any case, there is a logical fallacy in permitting capital reductions for correlation: the default rates are already measured in the context of a diversified portfolio and are an empirical measure of the default rate in the context of the overall portfolio. In effect giving capital credit for correlation is double counting.

In general, Standard & Poor's believes that capital should be viewed as supporting an ongoing lending operation capable not only of absorbing unexpected losses through a credit cycle, but of providing a cushion to permit continued operations. This contrasts with the kind of static pool analysis that aims only to cover worst-case losses and pay off all liabilities. This means that Standard & Poor's does not believe that the stated maturity of a loan should be a factor in the capital calculation, especially where these maturities can be artificially managed. Standard & Poor's supports the idea that all loans be assumed to be outstanding for the duration of a trough in the credit cycle, or three years. During such a cycle, there would be heightened rollover or extension risk, as banks are often not in a position to demand payment for fear of precipitating the bankruptcy of their clients. It also means that Standard & Poor's would want to see sufficient cushion in the capital requirements beyond the worst-case loss. For this reason, commercial loan risk weighting should be calibrated to a worst-case, recessionary experience rather than a one-year average default rate. PDs in a stressed scenario can vary significantly, by up to three times the average rate. Capital, if it is to provide a level of creditor protection consistent with investment-grade creditworthiness, should be set in expectation of a recession, as recessions are difficult to predict and capital is harder to raise once one has started.

For similar reasons, Standard & Poor's remains concerned that the capital relief from flattening the risk-weighting curve for successively stronger risk management may be too aggressive, and actually impairs capital protection and so potentially increasing systemic risk. The impact of these incentives on competitive dynamics is material, given the potential for a two-tiered banking system.

For similar reasons, while Standard & Poor's welcomes the incorporation of stress testing into the analysis of the robustness of banks' internal ratings based (IRB) systems, Standard & Poor's continues to believe that two consecutive quarters of zero growth is insufficiently taxing to be adequate, based on economic growth and bank performance over the past three economic cycles.

The retail sector has not experienced a significant recession in many years in some countries, so Standard & Poor's is wary of the PD calculations banks may be using.

Consumer lending in general will be, in Standard & Poor's view, undercapitalized at the investment-grade level, based upon the current proposals, unless very substantial levels of operational risk capital and, in some countries, interest rate sensitivity capital cushions are required. For the retail sector, Standard & Poor's also does not favor granting capital relief for the qualifying revolving loans based on the loss coverage provided by the high interest margins of such loans, but do consider this "cushion" in Standard & Poor's evaluation of a bank's earnings protection. Fundamentally, Standard & Poor's believes credit card and other unsecured consumer lending is a high-risk activity, for which banks earn high returns to compensate for the risks. Allowances for high or excess margin in capital calculations will make capital more cyclical, and require a commensurate supervisory and analytic focus on earnings.

While much progress has been made on the treatment of equity exposures, concerns remain regarding:

- Merchant equity and participations: Standard & Poor's favors a capital requirement for such investments that is closer to industry standards for private equity funds, many of which are entirely equity funded. We view equity risks as materially different than credit risks not just representing the lowest level of subordination in a company's capital structure. These equity risks are generally higher than credit risk and merit capital levels much higher than those for the highest risk debt instruments.
- Standard & Poor's is concerned that these risks could be substantially understated and result in deficient regulatory capital requirements for banks with such assets in times of difficulty. For example, "grandfathering" of some equity exposures, materiality tests for some equity investment, and discretionary treatment of shareholdings in state-supported industries, could substantially understate these risks and result in deficient regulatory capital requirements for banks with such assets in times of difficulty.

External Credit Assessment Institutions (ECAIs)

As expressed in Standard & Poor's response to the Securities and Exchange Commission's (SEC) Concept Release[3], Standard & Poor's supports an open and transparent process to designate rating agencies for any regulatory purpose, including the determination of ECAIs for the purpose of the accord.

The transparency of any designation process reduces regulatory barriers to entry and ensures that the markets remain the ultimate judge of the ratings process. Standard & Poor's continues to believe that the primary criteria of any authorization or designation should be the market's widespread acceptance of the rating agency as an issuer of credible and reliable ratings opinions. There is no one model or methodology for producing sound credit ratings. The critical issue for investors is whether the track record and experience over time demonstrates that the rating agencies' ratings prove to be credible and reliable.

[3] Standard & Poor's made its comments of July 28, 2003 in response to a Concept Release published by the SEC on June 4, 2003, entitled "*Ratings Agencies and the Use of Credit Ratings under the Federal Securities Laws*". A copy of Standard & Poor's response to the SEC and an accompanying letter from its president, Leo C. O'Neill may be found at www.standardandpoors.com/specialcoverage/sec.

Standard & Poor's strongly believes that designation criteria that are based on business or operational criteria would be flawed in principle because such an approach fails to recognize that there is no one model or methodology for producing sound credit rating opinions. Resources, methodologies, procedures, form of organization, and capitalization are, and should be understood to be, simply tools to be used by rating agencies in the performance of their rating analyses. It is the quality of the analyses upon which the rating agency builds its credibility and market acceptance. Designating criteria based on measures, such as performance mandates in the form of diligence standards, rating disclosure mandates, record-keeping requirements, capital and other financial resource requirements, and other government controls, would:

- Interfere with the very substance of the credit analysis and the credit rating process;
- Compromise the independence of a rating agency's analysis;
- Deter innovation in credit analysis and methodologies; and
- Result in homogenization of ratings analyses through government-prescribed minimum or uniform standards.

In such event, credit ratings no longer would represent the independent opinion of a particular credit rating agency. Mandated consistency of approach among various credit rating agencies could erode the individual quality and independence of the rating agency's credit analysis and potentially could stifle innovation in credit rating analytic technologies. Additionally, as a practical matter, such substantive designation criteria could impose additional costs on rating agencies and, consequently, market participants, with no clear evidence that these costs would benefit investors or the market.

Standard & Poor's recognizes that in markets with a shorter history of the use of ratings, such investor acceptance may be more difficult to gauge. In such cases, and in particularly in the case of the accord, where the use of ECAIs in bank regulation is entirely new, new processes may be called for. The most important aspect to Standard & Poor's, in any regulatory enfranchisement, is the transparency of the process and criteria for approval. Standard & Poor's believes that, within the ECAI recognition process as detailed in the CP3, attention to objectivity, independence, and transparency are appropriate, as is the testing of results against time or back testing.

As many markets that will adopt the accord have a shorter history of the use of ratings than the U.S., it is also critical to underscore that ratings are opinions only, and neither recommendations nor advice. This is true within financial markets and should be expressly designated as such within the accord.

Standard & Poor's continues to take issue with the idea of only one year of back testing of ratings as acceptable for ECAI approval. In the same way that one year of back testing would never be appropriate for a bank's IRB system approval, so one year's rating performance will be inadequate to judge the accuracy and credibility of an ECAI. Standard & Poor's continues to argue that the performance of ratings through the peak and trough of a full economic cycle is necessary to gauge the real performance of an agency's ratings, as this most recent economic cycle has so amply demonstrated.

Standard & Poor's remains concerned about supervisory discretion to consider whether or not to continue recognition of an ECAI that assigns unsolicited ratings. A rating agency's ability to assign ratings depends on the quality of the information it receives, whether from public or private sources. The arbiter of whether ratings, solicited or unsolicited, are useful to the market should be the market itself, and Standard & Poor's would hope, at a minimum, the quality and utility of any unsolicited ratings would be taken into account in any decisions made by supervisory authorities.

Securitization

The accord is intended to be neutral with respect to securitization, and Standard & Poor's supports that intent. However, it is difficult to reconcile the disincentives, indeed, penalties against securitization currently proposed with the accommodations made for other sectors, notably mortgage and retail credit. These accommodations serve to accentuate the ever-widening gap between the treatment of these on- and off-balance-sheet assets. Consistent and coherent treatment of assets across asset classes is imperative for the accord to be credible and to avoid market distortions.

Standard & Poor's concerns about the accord's treatment of securitization fall into two broad areas. Firstly, the possible impact of the effective discouragement of securitization on bank funding, financial intermediation, and availability of consumer credit. Secondly, the coherence in treatment for the credit risk of assets on an unsecuritized basis relative to the treatment of these same assets on a securitized basis, and other points directly related to the treatment of various aspects of asset securitization. These are treated separately below.

Market Impact

Standard & Poor's is concerned that attention focused so narrowly on the regulatory aspects and micro impact of various changes in the regulatory framework has caused the committee to downplay the cumulative impact at the macro level of the whole body of the accord on bank financing, disintermediation, and the availability of credit. Indeed, the credit deterioration in structured finance securities, evidenced by default and ratings transition studies, demonstrates that a meaningful level of risk has been transferred. While it is impossible to predict with accuracy how markets will respond to the accord, substantial disincentives could undermine the demonstrated benefits of securitization.

Impact on Bank Financing

The cumulative effect of the committee's efforts to reduce regulatory incentives for securitization will cause dislocations in the securitization market and so reduce a valuable financing avenue for banks and certain asset classes.

Impact on Capital Market Development and Disintermediation

Growth in disintermediation, defined as the direct funding of borrowers through the capital markets, instead of through banks, has been one of the keystones of financial modernization in the past 20 years. While beyond the direct responsibility of the committee, changes in bank regulation will have consequences for the development of this disintermediation and the efficiency of capital markets. In particular it could have an impact:

- On the provision of liquidity to all major sectors of the economy: residential and commercial mortgages, retail assets and bank commercial loan markets;
- On banks' ability to proactively manage risk in their balance sheets; and
- On economic growth or capital formation.

It is Standard & Poor's view that many aspects of the accord could distort growth and development of the international capital markets. These include:

- A significant decrease in securitization volumes in both the U.S. and the European markets. Investors are unlikely to accept 'straight' bank paper or 'covered bonds' instead of asset-backed securities (ABS) without some pick-up in yield on these instruments, with the consequent possible increase in the costs of bank wholesale funding and the cost of credit. To emphasize the volumes involved, $550 billion of retail securitizations were issued in the U.S. in 2002, and $100 billion in wholesale transactions (CLOs, CDOs, etc.). In Europe, the equivalent was $100 billion and $35 billion, respectively. These volumes represent only a single year's activity that would need to be added to the bank's core funding in a worst case.
- The treatment of corporate assets within the accord. Under the Standardized Approach, unrated corporates are more generously weighted than those corporates rated below 'B-'. This may cause borrowers who previously tapped the bond markets to forego attractive funding opportunities there so that their banks need not take their public rating into account for capital calculation purposes. These assets will thus be far more generously treated on banks' balance sheets than they would otherwise have been, thereby understating banks' required capital, with no market reference price or credit quality reference. By underweighting higher risk corporate assets, corporates will be tempted to turn toward banking markets and away from bond markets. In a future contracting credit cycle, this will leave banks far more exposed to corporate credit risk than they were in the 2000-2002 downcycle. This would exacerbate bank loan losses and credit contraction in the economy, and increase the volatility of the economic cycle. The risk dispersion resulting from disintermediation, securitization, and credit derivatives is critical to limiting the impact of the past credit cycle on bank profitability and solvency.

Treatment of Securitized Assets

Standard & Poor's welcomes the likelihood of reduced possibilities for capital arbitrage and appropriate capitalization of retained risks contained in the CP3 regarding securitization. By the same token, Standard & Poor's concurs with previous statements by the committee that the accord should be neutral with respect to securitization, providing neither incentives nor disincentives to its use. We believe the unduly harsh treatment of certain aspects of securitization provides clear disincentives to using securitization, and goes against the original stated intention of the accord. The credibility and acceptability of the accord depends heavily on equal treatment of equal risk. It is Standard & Poor's perception that the capital requirements for securitization with respect to retail and corporate assets, as proposed in the CP3, is inconsistent relative to their treatment of unsecuritized assets in several regards.

Standard & Poor's fundamental philosophy is that for structures that do not transfer a meaningful amount of risk, capital should be the same as it would be for on-balance-sheet assets, or (K_{IRB}) in the language of the accord. As a corollary, capital relief should be based on the credit risk transferred to investors. First-loss tranches held by originating (or investing) banks can frequently represent the vast majority of expected loss of the whole pool of assets resulting, in Standard & Poor's view, of minimal tangible risk transfer. Any effective system for calculating a capital charge for securitizations must be based on the degree of risk transfer that is taking place. To the extent that the size of the first-loss tranches are generally equivalent to the K_{IRB} amount of capital required, or the amount that Standard & Poor's own capital models would require, it is consistent that capital be deducted dollar-for-dollar for such instruments, as an equivalent to adding back all related securitized assets to the transaction on balance sheet. However, any portions of such tranches sold constitute risk transfer and so deserve capital relief. Where real risk transfer has occurred, in full or in part, the result for the asset seller should be less than K_{IRB}. In no case, however, is it logical that the deduction method would use more capital than the K_{IRB} calculation would.

Unfortunately, the proposals, as presented in the CP3, in attempting to cover all types of asset securitization with the same risk formula, do not achieve the aims spelled out above. Rather, they strongly penalize some aspects of securitization and overweight credit risk for securitizations relative to comparably weighted unsecured assets.

The formula used to derive the capital weightings for all securitizations has a consistently higher PD and higher expected loss (EL) than those used for the same underlying assets when they remain on-balance sheet. In particular, the constant EL of 50% for senior securitization positions that stands behind the weightings in the CP3 is overly conservative compared with both the theory behind securitization and Standard & Poor's published history of losses on ABS.

The assumption appears to penalize securitization, which, except for reversion to K_{IRB}, will consistently result in a greater total capital requirement than corresponding on-balance-sheet assets.

For example, if one institution owns both the senior and subordinated tranches of a rated securitization, the holder would calculate the weighting of the senior tranche, determine if it was greater than K_{IRB}, and choose the weighting accordingly. It would do the same for the subordinated tranche, which supports the losses for the senior tranche. Given the proposals in CP3, the holder would have to allocate K_{IRB} to the senior tranche, effectively treating the assets as if they were on-balance sheet, and then be obliged to deduct the subordinated tranche from capital, thereby reserving capital for the same assets twice. The example demonstrates just how far away from "neutral" the securitization proposals have become. For this reason, an objective test to determine where real risk has occurred would be preferable to the current proposals.

It is also worth exploring whether it would be appropriate to differentiate the ratings based approach (RBA) by asset class, as has been done in the standardized approach and IRB methods for credit risk. Though Standard & Poor's would caveat this by recognizing such classes would then have to be adjusted by geography, or made sufficiently broad to encompass asset performance in all geographies where such assets were securitized. While Standard & Poor's believes the retail treatment under IRB in CP3 is too generous, Standard & Poor's believes the treatment of these assets should be consistent whether they are on balance sheet or securitized.

With regard to proposals in CP3, Standard & Poor's has a number of other observations:

- The number of underlying credits in the asset pool should not be a factor in the RBA approach as it is already taken into account in the rating process.
- The aggregate capital held by the holders of a well-distributed securitization transaction will far exceed the risk on the underlying assets. The relative penalty of holding lower-rated securitization tranches versus lower rated corporate loans is too great and does not fully reflect risk diversification and other benefits. Specifically, positions rated 'BB' and below should be deducted from capital only for loss bearing tranches. It is entirely possible that senior tranches could have these ratings. While they would need capital weightings commensurate with their risk, a senior tranche rated 'BB' and a junior, loss-absorbing tranche rated 'BB' should experience similar PDs, but very different ELs.
- The RBA risk weights on 'AAA' and 'AA' tranches are lower than those used in the standardized approach, but the RBA weights on tranches below 'BBB' are higher than in the standardized approach. The reasoning for this is not given.
- Standard & Poor's agrees that revolving credit card facilities need significant credit supports. In fact, Standard & Poor's believes the use of spread income alone to provide cover for these transactions is adequate only where such cover has proven sufficient under all reasonable scenarios to cover all losses. However, Standard & Poor's believes the issues of adequate coverage are specific to credit card transactions and not to all revolving securitizations, particularly now that CP3 has addressed early amortization features specifically. We do not believe the provisions as written should necessarily be assimilated to any revolving transactions for any asset class. Perhaps the differentiated treatment by asset class could also go some way to resolving this issue.

- Under the supervisory formula for originators within the IRB category, there is a floor capital charge of 56 basis points for any retained portion of an ABS. Standard & Poor's understands that it may be desirable at the outset of the accord's implementation to limit capital reduction stemming from the IRB method, in parallel with the way this has been done for on-balance-sheet mortgages as well as for total capital for credit risk. However, Standard & Poor's believes that this measure also should be transitory, until supervisors become comfortable that banks are not understating the risks of their retained securitization tranches. It would also be useful to understand how the committee arrived at this figure.
- Standard & Poor's believes synthetic transactions should receive equivalent treatment as cash transactions, with an incremental addition for any additional counterparty risk. Indeed, the only incremental risk that Standard & Poor's can concede in these transactions is some third-party counterparty risk where there is exposure to an unrelated third party doing what is expected of them in the course of the transaction. However, in such cases, at least for the RBA method, Standard & Poor's criteria requires that any third-party counterparty — liquidity provider, swap provider, etc. — be of commensurate quality to that of the rating assigned to the rated issue.

Liquidity Facilities

For reasons of consistency of treatment, Standard & Poor's believe that liquidity facilities should be weighted as a function of their terms and their likelihood of drawing, and not the purpose of the liquidity facility. Simply put, liquidity facilities written so strictly as to be effectively third-party guarantees should be treated as such. At the other end of the spectrum, facilities that promise nothing, should receive low, or zero weightings. The application of this principle should be consistent regardless of to whom the facilities are made available. Similarly, facilities that have contractual access to collateral should be weighted in the same way as any facility that benefits from collateral.

Standard & Poor's is concerned that the treatment of liquidity facilities incorporated in securitization transactions in the CP3 may send a mistaken signal to the market about the utility of such facilities. While Standard & Poor's agrees that a 0% credit conversion factor (CCF) is appropriate for an instrument that entails no practical exposure for the banks that offer them, Standard & Poor's is concerned that formal adoption of general market disruption (GMD) facilities within the CP3 framework may validate, perpetuate, and extend the use of GMD facilities, which Standard & Poor's feels would not be appropriate in light of the foregoing considerations. Should such facilities genuinely cover routine liquidity needs specific to asset/liability mismatches in operating companies or structured financings, then such a zero weighting would be inappropriate.

Operational Risk

Standard & Poor's is a strong proponent of assessing the level of operational risk as part of determining the overall creditworthiness of a financial institution. However, Standard & Poor's definition of operational risk is wider than that used in the CP3, and includes strategic and reputation risks.

Standard & Poor’s remains cautious about overreliance on any models — operational risk value at risk (OpVaR) or the loss data approach — as a means of accurately measuring operational risk, due to the lack, quality, or diversity of available data. Additionally there is the potential for false confidence implicit in statistically quantifying qualitative data to anticipate unexpected loss.

Overall calibration — arising from QIS3 and reflected in CP3 — of the system-wide operational risk capital charge has come down to only 12% from 20% in 2001. Standard & Poor's continues to believe, as stated in 2001, that the average minimum capital consumed to cover a broad array of operating risks is closer to 30%, albeit on a wider definition.

Standard & Poor's continues to believe that not all financial institutions will need to develop such complex operational risk-modeling techniques, because the complexity of their operational risks do not justify the costs of developing such systems.

While Standard & Poor’s may dispute the definition, calibration, scope of application, and quantity of capital attributed to operational risk, the decreases in regulatory capital projected by QIS3 clearly need to be compensated by increased capital elsewhere within the regulatory framework, to ensure the continued soundness of the global financial system. Therefore, while Standard & Poor's may dispute the mechanics, it supports the need for some means of compensating the decline in bank capital attributable to credit risk from The Accord.

Pillar 2 — Supervisory Review

The supervisory challenge of implementation is significant. The framework is complex, capital market innovation is robust, and regulation in most markets has lagged market practice.

Implementation must ensure that supervisory standards are consistent globally. That “national discretion” does not become a euphemism for the use of a country’s banking system to promote economic advantage. Several key areas of banking risks — interest rate risk, concentration risk, severe discontinuous shocks not captured by the credit risk framework — are specifically allocated to supervisory review. This increases the importance that national discretion is exercised appropriately.

In addition, Standard & Poor’s is concerned that the lack of a forward looking aspect to the accord removes banks’ and supervisors’ abilities to anticipate changes in the banking market or a bank’s risk profile. The absence of any such mechanism only confirms the need for a substantial capital cushion beyond that required for already identified credit and operational risk.

Supervisory intervention must be timely to offset the inevitable cyclicality that is implicit in any risk-based capital framework. Greater transparency and market discipline, if effective, may also put added pressure on bank supervisors to act quickly. Indeed, to the extent market discipline is effective, regulatory forbearance may be limited. A judgmental overlay required of supervision is material and necessary. Stress testing of credit behavior, standardized interest rate shocks, and judgments about and treatment of credit concentrations all become more meaningful in an environment of more efficient capital use. This is especially the case as the capital requirements were benchmarked to credit behavior stressed only to a modest degree, and then made increasingly accommodative in the foundation and advanced IRB approaches.

Pillar 3 — Market Discipline

Enhanced disclosure is an essential part of greater regulatory reliance on the bank's internal risk measurement processes as a determinant of regulatory capital requirements. The recommended disclosures, if made, will enhance sophisticated market participants' knowledge and understanding of risk management policies and risk profile of reporting institutions, and make the regulatory validation process for IRB more transparent. While the reporting will be incrementally helpful for major institutions, it is most helpful for the banks where capital markets related risk transfer activity is greatest, and failure represents an increasing potential for systemic risk. Even without public disclosure, the thrust of the risk measurement requirements of the proposal should enable institutions to communicate their risk profile and practices, and will facilitate the dialogue between bank managements and the analytic community.

Standard & Poor's agrees that some increased level of credit risk disclosure on portfolios subject to IRB approaches be mandatory. However, given the lack of established track records, the integrity of internal risk ratings systems, and related estimates of exposure at default (EAD) and loss given default (LGD) will be judged over time as these risk estimates are measured against subsequent experience.

Standard & Poor's believes that information on the performance of internal risk rating systems should be subject to greater disclosure. While many banks provide some of this information currently in the rating process, banks vary in their capacity, and in some cases their willingness, to provide this information. The transparency of performance measurement of internal risk rating systems is a crucial underpinning of the success and credibility of the new accord. Standard & Poor's has recommended, and continues to believe, that the default and rating transition reporting framework used by the external credit assessment providers is an appropriate disclosure framework, and that disclosure in this area by large banks should be accelerated. Stronger disclosure of the performance of internal credit assessments will allow market participants to judge the core credit competency of reporting institutions. It also supports development of securitization and risk transfer activities, and is also crucial for benchmarking exercises that banks are engaging in. This disclosure, taken collectively, and combined with disclosure on exposure distribution, could provide valuable insights into the changing risk tolerances of institutions, the impact of economic cycles, and systemic risk, and so enhances comparisons across institutions and systems.

The qualitative disclosures on securitization may overlap emerging accounting disclosure, and Standard & Poor's urges that the committee conforms its specific requirements to accounting or securities law requirements where applicable. The quantitative disclosure requirements for securitization should be considered in the context of financial innovation, and the continual requirement to adapt or modify these requirements is a response to changing market conditions. Standard & Poor's concurs with the requirement that banks report retained risk. We believe the discussion of policies, particularly the intent and purpose of transactions that are material to the IRB capital calculation, are vital to understanding the management of capital within the IRB framework. It is consistent with Standard & Poor's focus on the policies motivating and supporting securitization and purported risk transfer transactions.

Despite these positive comments on behalf of sophisticated investors, Standard & Poor's is concerned about the "ordinary" investor's ability to use the new information. Greater disclosure is no doubt an improvement to the market overall. But there is the risk that investors may be overwhelmed by the sheer volume and complexity of the information, which could obfuscate a bank's risk profile. At worst, the quantitative disclosures may mislead investors regarding risk profiles — especially to the extent that estimates of portfolio risk incorporate internal risk rating systems and EAD and LGD estimates that are based on limited historical data.

Appendix 1
Concerns Remaining From Previous Consultation Papers

The Standardized Approach

Public Sector Entities (PSEs)

CP3 has retained “national discretion” over whether PSEs are weighted the same as governments, one category lower, or based on ratings from ECAIs. It suggests that where a country uses this discretion, supervisors from other countries may weight claims on such institutions in the same manner. Standard & Poor's continues to believe that it is both inappropriate and misleading to evaluate automatically PSEs as risks equivalent to, or one category lower than, the sovereign rating. We are concerned that this will discourage, rather than encourage, greater attention to the assessment of credit risks among banks using the standardized approach. Given the discretionary treatment at the national supervisory level, banks and borrowers alike could end up with significant inconsistencies in the treatment and thus weighting and pricing of their risks, inconsistencies that would abet competitive inequalities and hinder transparency.

The economic role of governments in many countries is undergoing considerable transformation. Increasingly, governments are relying on market mechanisms to address the inefficiencies of the public sector. Even where privatization is not currently on the political agenda, policymakers worldwide are showing a growing tendency to expose remaining government-supported entities to market discipline.

In recent years, Standard & Poor's has adjusted its methodology for rating government-supported entities to reflect these trends. Whereas 20 years ago, ratings of such institutions were most often equalized with the ratings of their owner-governments, Standard & Poor's analytical approach has shifted towards (i) an increasing focus on the "stand-alone" credit quality of the entity, and (ii) determining the durability of the entity's links with the government. This approach aims to ensure government support is measured consistently and, where there is evidence that support is being reduced, that greater weight is given to stand-alone credit factors when determining the appropriate issuer rating.

Standard & Poor's analytical approach reflects the following:

- There is evidence in a growing number of countries of a reduction in government commitment and support for PSEs. The privatization of enterprises, including entities once thought to be a permanent part of the public sector, are now relatively commonplace. Occasional defaults of public sector enterprises have been allowed to occur. Many governments' official statements of support for PSEs have become weaker or less clear-cut.
- The widespread sale of state enterprises and policy developments — such as competition policy in the European Union (EU) — are not only encouraging privatization but, equally important, are discouraging the use of government guarantees and other forms of ongoing state support.

Regardless of the outcome of the deliberations on this subject, and the ultimate treatment chosen by national supervisors, Standard & Poor's will continue to look at state's obligation to these PSEs as contingent liabilities when Standard & Poor's believes the government has a legal or moral obligation to support them. To the extent that Standard & Poor's believes the government is effectively providing its implicit guarantee or safety net to these institutions by giving them preferential regulatory treatment, Standard & Poor's will continue to add these effective contingent liabilities to the debt burden of the sovereigns in question.

Regional and Local Governments

The same national discretion is permitted for local and regional governments as for PSEs, albeit with the recommendation that such entities receive the same treatment as the sovereign only where "these governments and local authorities have specific revenue raising powers and have specific institutional arrangements the effect of which is to reduce their risks of default". As above, Standard & Poor's believes this will lead to distortions in the treatment and thus weighting and pricing of their risks and possibly be perceived as effectively providing a guarantee or safety net where none was intended.

Claims on Banks

Option 1 for the treatment of claims on banks would, in Standard & Poor's view, penalize better-quality banks and could benefit weaker institutions. If a sovereign were rated 'AA', for example, the highest rating any bank could get would be 'A', which would penalize banks with higher ratings, while weaker banks that might be rated 'BBB' would also be treated as 'A' rated. Use of this method might also implicitly suggest that the sovereign would come to the rescue of any regulated bank, a development that could be negative for the sovereign's creditworthiness and that is also at odds with the worldwide trend toward less government support for banks.

Claims on Corporates

The committee's most recent draft retains a lower risk weighting for unrated corporates than for exposures rated below 'B-'. Standard & Poor's recognizes that the initial intention of this clause was to avoid penalizing small and midsize enterprises (SMEs). However, the treatment of SMEs has been changed in The Committee's most recent draft while this provision has been retained.

This weighting is equivalent to a default rate per asset of 8%, assuming a three-year average default rate, which effectively attributes these assets with risk characteristics in the 'BBB' category. Standard & Poor's bank rating business and the portfolio analysis Standard & Poor's does for CDOs demonstrates that most banks' corporate portfolios are, on average, of somewhat lower than 'BBB' quality. This provision may leave banks undercapitalized. In addition, Standard & Poor's reiterates the financial incentive this provides to banks to reduce information, and thus transparency, on the credit quality of bank assets.