Basel's Recent Proposals on Bank Exposures and the Caveat of Insufficient Bank-Sovereign Risk Delinking

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Two recently published consultation documents by the Basel Committee for Banking Supervision (BCBS) carry in our opinion heightened relevance for banks' exposures to the credit risk of other banks. Such exposures represent a very significant share of almost any bank's risk portfolio, due to the very nature of banking activities. This report summarises the issue, highlighting also the positives and caveats.

In summary, should the provisions of these consultative documents be adopted and eventually implemented, the risk weights (RWs) and thus the capital charges of banks' exposures to other banks would be determined primarily by external credit ratings – in jurisdictions which do not prohibit the use of ratings for regulatory purposes. This is so because (i) in those jurisdictions the standardised approach (SA) will use external ratings on banks as the main criterion for RWs, and (ii) internal ratings-based (IRB) approaches will no longer be allowed for exposures to banks and other financial institutions (in addition to large corporates and equities) – thus leaving the SA as the only option.

We caution that the consequences of the BCBS proposals could be material and could challenge some key post-crisis regulatory goals – namely, (i) de-linking bank risk from sovereign risk (a key driver of the persistence and depth of the financial crisis in Europe) and (ii) reducing the excessive reliance of bank credit decisions on ratings still provided to an excessive extent by an oligopolistic rating industry. This should not be the case in jurisdictions not using ratings for regulatory purposes, where bank-specific regulatory metrics would be used instead for bank counterparty RWs.

Banks' exposure to bank risk: two recent BCBS consultative documents

Consultative document on standardised approach (December 2015). This document, titled "Revisions to the Standardised Approach for credit risk", is a turnaround from the proposal published a year before – which had called for the reduction or removal of normative reliance on external ratings when setting banks' regulatory capital charges under the standardised approach (SA). The current proposals are as follows:

- **External Credit Risk Assessment Approach (ECRA):** In jurisdictions where the use of ratings for regulatory purposes is allowed, ratings would be the primary factor for determining RWs. To reduce "mechanistic reliance" on ratings, due diligence would be required, which could result in a higher risk weight than determined by ratings. In order to provide market discipline, banks should be required to publicly disclose information about their credit assessment approach.

  The 'base' RW (determined by the rating alone) would be 20% (AAA to AA- ratings), 50% (A+ to BBB- ratings), 100% (BB+ to B- ratings) and 150% (below B- ratings). For short-term interbank exposures (original maturities of three months or less) the corresponding base RWs would be 20% (AAA to BBB- ratings), 50% (BB+ to B- ratings) and 150% (below B- ratings).

- **Standardised Credit Risk Assessment Approach (SCRA):** In jurisdictions where the use of ratings for regulatory purposes is not allowed, and for unrated exposures in all jurisdictions, banks would classify exposures to other banks into three buckets, as follows:
  - **Grade A:** Bank counterparties with adequate capacity to meet their financial commitments irrespective of economic cycles or business conditions. Provided they exceed their minimum regulatory requirements (capital, leverage, buffers, liquidity), the RW would be 50%.
  - **Grade B:** Bank counterparties which are subject to substantial credit risk. If at least one buffer is not met, the RW would be 100%.
  - **Grade C:** Bank counterparties with material default risks and limited margins for safety. If minimum required regulatory requirements are not met or external auditors have issued an adverse audit opinion or expressed doubts about the ability to continue as a going concern, the RW would be 150%.

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Importantly, the December 2015 consultative document states: "The Committee believes that banks' external ratings as used for regulatory capital purposes should exclude government support", adding that government-owned banks are excluded from this requirement. The document notes that this requirement is in line with "the objective of breaking the link between banks and their sovereigns" (which is also achieved by eliminating from the current framework the option of risk-weighting bank exposures based on their sovereigns' ratings).

In regards to the macroeconomic environment in the credit risk assessment of a bank counterparty, BCBS considers that this should be part of the external rating assessment of the bank. In the case where external ratings are not available, the macroeconomic risk may be reflected by incorporating country ratings (e.g. OECD country ratings) as an objective criterion for each grade bucket, or by imposing a floor derived from sovereign exposures' RWs. That said, BCBS clarifies that it is still in the process of reviewing the treatment of sovereign exposures for capital purposes "as part of its broader and holistic review of sovereign-related risks."

Exposures to securities firms and other financial institutions will be treated as exposures to banks provided their prudential standards and supervision levels are equivalent to that of banks.

The RW for equity holdings would be 250% and for non-equity capital securities and subordinated debt 150%, unless these instruments are deducted from regulatory capital.

Consultative document on internal ratings-based (IRB) approaches (March 2016). In this document, titled "Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches", among various other proposals, the BCBS calls for the removal of both IRB approaches (Advanced and Foundation) from the portfolios of (i) banks and other financial institutions (including insurance companies), (ii) large corporates (consolidated group assets exceeding EUR 50 billion), and (iii) equities. As a consequence these portfolios would be subject solely to the SA.

The document justifies this proposal by stating that "one of the lessons of the financial crisis is that not all credit risk exposures are capable of being modelled sufficiently reliably or consistently for use in determining regulatory capital requirements". The document goes on to note that, for credit exposures to banks and large corporates, "it is unlikely /…/ that banks' internal estimates of potential defaults or losses from such exposures will be any more reliable from a supervisory perspective than using estimates based on market data, on which the standardized approach to credit risk is based."

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Positives and caveats of BCBS's proposals

Positives:

- Despite the proposal to use external credit ratings as the primary basis for determining RWs (in jurisdictions allowing the use of ratings in regulation), we welcome the fact that BCBS also introduces due diligence requirements to reduce "mechanistic reliance on ratings". This shows the Committee's justified concern that the mechanistic reliance on external ratings to assess bank counterparty risk can produce sub-par outcomes, the likes of which were painfully felt during the financial crisis.
- We view as very positive the Committee's proposed requirement that external ratings on banks for RW purposes exclude government support, bearing in mind that the bank-sovereign circular risk loop proved to be intensely harmful and heightened the sovereign crisis in the euro area (EA). By the same token, the proposed removal of the link of a bank's RW with the rating of its home sovereign – which is the case with the current SA – is in our view another useful step in the same direction.
- In general, as long as material caveats and effective due diligence process are in place, we consider that relying on properly explained credit ratings can bring a degree of consistency across geographies and business models. This could have a beneficial effect on cross-border interbank markets, among other things, which were badly hurt by the financial crisis and led to the collapse of confidence of banks in other banks – especially across borders.
- We also consider as a positive that the RW of bank counterparties in jurisdictions not allowing the use of ratings in regulation (e.g. the Dodd-Frank Act in the US), or which are not rated, will be bucketed in terms of compliance with prudential metrics and capital buffers. This in our view adds clarity to the process, representing also an extra incentive for all these regulatory parameters to be fully and transparently disclosed on a regular basis. Importantly, it also represents an option which, by excluding any element of expected government support, allows for a clearer delinking of banks from their sovereigns.

Caveats:

- As much as the Committee's proposals aim to delink bank and sovereign risk by requiring bank ratings to exclude government support, the fact remains that most of the incumbent rating agencies continue to embed expected state support in their large-bank ratings – even if to a smaller extent than in the past due to resolution regimes. This is true for EA banks as well, even though these are now part of the Banking Union and supervised via the Single Supervisory Mechanism (SSM). This aspect could in our view be a material shortcoming of the new BCBS proposal, as the bank-sovereign credit loop partially remains in place.

  We note that it is generally the largest banks which are the most meaningful counterparties in cross-border interbank and financial markets. Our view is that neither banks nor their supervisors should plausibly be comfortable with basing even partially the credit assessment of a non government-owned bank counterparty on the expectation (not on the legal certainty) that state support may be forthcoming on a timely basis should the bank counterparty fail.
- By the same token, we highlight that most of the incumbent rating agencies continue to apply sovereign ceilings to bank ratings, including for banks in the EA – which again are supervised through the SSM. This in our view is another shortcoming of many bank ratings as it preserves a material degree of bank-sovereign risk loop. We note that the December 2015 BCBS document has not flagged this aspect. By placing regulatory value on external bank ratings without addressing the sovereign risk loop in outstanding rating approaches the consultative document, if adopted in its proposed form, could end up perpetuating it.
- Through the proposed due diligence process called for by the December 2015 document, a bank can decide on a higher RW than the 'base' RW (determined by the rating alone). We would caution, however, that in practice this is not likely to happen often. Loosely comparing the outcomes of SA vs. IRB approaches with respect to RWs, the latter are likely to be lower than the former. The proposed RW for banks with ratings in the 'A+ to BBB-'range would be 50% – and we point out that most major bank counterparties would be rated in this range. In practical terms, it is rather unlikely that a bank's internal due diligence process would lead to a view of a bank counterparty as being lower than as represented by external credit ratings, and thus

end up with a RW of 100% (if this were the case, we assume that the bank would avoid the respective bank counterparty altogether). In our opinion, banks' future due diligence regarding counterparty risk assessment could be strengthened via explicit supervision of this area. In the EU such due diligence aspects could be part of SREP.

- Last, but not least, we caution that in practical terms, for jurisdictions where ratings can still be used in regulations, the BCBS proposals would to a significant extent transfer credit decisions regarding a very material part of a bank's risk assets (exposure to other banks), in Europe and beyond, to the very few large players which continue to excessively dominate the industry. In this context, future reliance by banks on a wider and more diverse range of rating providers – to the extent that their views are credible – could add value to their overall risk assessment for bank counterparties.

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