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Basel's Proposed Revisions to the Standardized Approach for Credit Risk: Positive for Consistency and Transparency

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On 22 December 2014 the Basel Committee for Banking Supervision (BCBS) published a consultative document proposing revisions to the Standardized Approach (SA) for credit risk. Scope Ratings views it as a very relevant regulatory initiative to change the approach to credit risk weights (RWs) under the SA. This is a significant part of the BCBS's broader effort to address inconsistencies in banks' risk-weighted assets (RWAs) – leading to what some already start to call Basel 4.

Key general takeaways

- This is BCBS's first meaningful change to the SA for credit risk since it was first adopted as part of the initial Basel 2 (first draft in the late 1990s).

- In proposing these revisions the BCBS aims to improve the SA in a number of ways: (i) reducing or even removing regulatory reliance on external credit ratings; (ii) increasing risk sensitivity (in a post-crisis framework); (iii) reducing national discretions (which have led to regulatory arbitrage across geographies); (iv) strengthening the link between the SA and the internal ratings-based approach (IRBA) for credit risk; and (v) enhancing comparability of capital requirements across banks.

- We believe that the current SA proposals broadly reach their stated goals, although further adjustments are necessary and will likely take place before the final version is published -- probably later this year.

- Taken in conjunction with another consultative document issued the same day by the BCBS and which deals with new capital floors based on the new SA, it is plausible that the proposed framework would make the SA more appealing for banks, possibly to the detriment of the IRBA. Specifically, on the one hand, the SA would become more transparent, more dynamic and with definitions closer to the IRBA, while on the other hand additional constraints are being placed on the advantages of using the IRBA (which allows banks to use their internal ratings for credit risk, subject to their supervisors' approval).

- We would not be surprised if in the future national supervisors specifically recommended banks to look closer at the SA, especially if the new RWs did not penalize lending to the real economy more so than under IRBA (with regulatory constraints and capital floors). We also remember that Basel 2's IRBA was chosen by large banks in the pre-crisis years with the goal of "optimizing" regulatory capital (and thus make it closer to what they used to define as economic capital) – which of course would be less of a winning strategy in the highly regulated post-crisis world.

- In our view, one positive aspect of the new proposals is the reduction or removal of the normative reliance on external ratings when setting banks' regulatory capital charges under the SA. Following the ratings turmoil at the beginning and height of the financial crisis, this step was called for by the FSB as early as October 2010, when it issued a set of principles for reducing reliance on external credit ratings in standards, laws and regulations.

- Another net positive of the BCBS proposals is in our opinion the more realistic and consistent RW treatment of real estate exposures – residential and especially commercial. For residential real estate credits we view positively the fact that RWs would be based on whole-exposure loan-to-values (LTVs) and also on the borrower's debt service coverage (DSC) – from 25% for LTV<40% and DSC<35% to 100% for LTV>100%. For commercial real estate (CRE) we note the two options – either considering CRE exposures as unsecured and thus applying the respective RW of the borrower (based on the new SA standards – *see below*) or applying RWs based on LTVs – from 75% for LTV<60% to 120% for LTV>75%. This new approach in our view is more appropriate in light of the problems experienced during the crisis by banks exposed to CRE (which to this day continue to generate high credit expenses).

- We note that the SA treatment of sovereigns and public sector entities is not within the scope of the document, as the BCBS will consider these as part of "a broader and holistic review of sovereign-related risks". However, we would assume that similar objectives will be pursued in that assessment as well.

Replacing external credit ratings with simple and transparent risk metrics

- Bank exposure RWs would no longer be calculated by reference to external ratings – either under Option 1 (derived from the rating of the bank's home sovereign) or under Option 2 (based on the bank's own rating). RWs would instead be based on two risk drivers, related to (i) capital – measured as the Basel 3 CET1 ratio – and (ii) asset quality – measured as a net non-performing asset (NNPA) ratio. The BCBS stated that it considers these metrics as good predictors of bank failure. RWs would range from 30% (CET1=>12% and NNPA<=1%) to 140% (CET1 at 4.5%-5.5% and NNPA>3%), with a 300% RW for CET1<4.5% or with necessary data not being disclosed according to Pillar 3 requirements – *see table below*. Short-term interbank claims (less than three months) may receive a RW 20% lower than the normal equivalent – with a floor of 30% -- provided they are not in fact roll-over facilities.

	CET1 ratio ≥ 12%	12% > CET1 ratio ≥ 9.5%	9.5% > CET1 ratio ≥ 7%	7% > CET1 ratio ≥ 5.5%	5.5% > CET1 ratio ≥ 4.5%	CET1 ratio < 4.5%
Net NPA ratio ≤ 1%	30%	40%	60%	80%	100%	
1% < Net NPA ratio ≤ 3%	45%	60%	80%	100%	120%	300%
3% < Net NPA ratio	60%	80%	100%	120%	140%	

Source: Basel Committee on Banking Supervision

- Corporate exposure RWs would similarly no longer be based on external ratings but on two specific risk drivers which the BCBS believes have a high level of explanatory power while preserving simplicity, namely revenue (vs. profitability which may create "misaligned incentives") and leverage (assets/equity). Based on these metrics RWs would range from 60% (revenues>EUR 1bn and leverage at 1x-3x) to 130% (revenues<=EUR 5m and leverage>5x), with a 300% RW for corporates displaying negative equity – *see table below*. The BCBS believes that the new standards take account of the fact that a large majority of corporate borrowers, especially SMEs, do not carry external ratings, and also that the RWs are less likely to unduly penalize SMEs.

	Revenue ≤ EUR 5m	EUR 5m < Revenue ≤ EUR 50m	EUR 50m < Revenue ≤ EUR 1bn	Revenue > EUR 1bn
Leverage: 1x - 3x	100%	90%	80%	60%
Leverage: 3x - 5x	110%	100%	90%	70%
Leverage > 5x	130%	120%	110%	90%
Negative equity[1]	300%			

[1] Negative equity means that a corporate's liabilities exceed its assets.

Source: Basel Committee on Banking Supervision

- Finally, without getting into the technical details we note that reduction of external rating reliance is also contemplated for (i) financial collateral (debt securities) which would be eligible under the credit risk mitigation framework, as well as for (ii) providers of credit protection.

Positives and caveats for the proposed bank exposure RWs

Positives:

- In our opinion the main positive of the end of regulatory reliance on external ratings is the significant de-linking of bank credit RW from sovereign risk. We note that under the current Option 1 bank RWs are directly derived from external sovereign ratings, but the situation is not much different under the current Option 2 either (external ratings for the banks themselves), due to the fact that US rating agencies typically either link or use sovereign ceilings for bank ratings. Relying on the risk drivers mentioned above would in our view eliminate this structural inconsistency.

- A bank's RW would also be more predictable and the criteria more clear, as often some external bank ratings are based on more cumbersome and sometimes controversial methodologies. As a very specific example, we note that several agencies notch up bank ratings based on expected sovereign support, which in fact may distort the fundamental credit view on the bank itself as a counterparty. Indeed, banks providing credit to other banks would not be reassured by the consideration of sovereign bailouts being their last line of defense if this can be avoided to begin with.

- The proposed standards address both the transparency and the consistency challenges although more adjustments are probably needed in this respect.

Caveats:

- We believe that the reliance of the chosen metrics (especially the NNPA ratio) on Pillar 3 disclosure may not be sufficient at this time, as Pillar 3 reporting occurs only once a year. Metrics based on quarterly disclosure may be a more helpful outcome, especially as the financial situation of some banks can change relatively fast.

- While risk drivers related to capital and asset quality are certainly central to a bank's risk assessment, thus highly relevant for RWs, what may be missing are metrics related to liquidity and funding. Indeed, the crisis years showed banks' high vulnerability to liquidity and funding shortages – especially those banks with significant levels of market funding (notably short-term). One possible metric in this respect could be the LCR, later perhaps supplemented by the NSFR. An alternative to this could be the loan-deposit ratio – although some long-term market funds (like covered bonds in some jurisdictions) may be in fact stickier than deposits. As for the CET1 ratio, it may later on be supplemented by a leverage ratio when it becomes effective.

- Although the two chosen risk drivers (CET1 and NNPA) are supposed to be business model-neutral, we believe that in fact they may impact wholesale and investment banks less than retail and commercial banks. This is primarily because of the absence of funding and leverage metrics. Specifically, a wholesale-funded entity with a reduced loan portfolio (which is typically the case for investment banks) could potentially benefit from a lower RW under the SA than a retail or commercial bank which is top-heavy on loans.

- Some banks could potentially circumvent the less-than-three-month maturity condition for interbank exposures benefitting from a lower RW by having the facility renewed after a short interruption at the three-month maturity rather than directly rolling it over.

- Importantly, we believe that some RWs need a better calibration across credit sectors. As one example, a large bank with an acceptable capital ratio (e.g., CET1 of 9.4%) and slightly below-average asset quality (e.g., NNPA of 3.1%) would obtain the same RW as a small leveraged SME (e.g., EUR 3m and 2.9x leverage).

Likely adjustments

- As said above we do not expect this document to be the final version of the new SA standards. In fact the BCBS consultative document is issued for comment until 27 March 2015. It is likely that some institutions, especially retail and commercial banks, will object to some of the provisions which they consider comparatively harsher for them – for example on regulatory retail exposures or on real estate exposures (especially residential). In this, they will probably be supported by their national supervisors, and politicians may also join the debate.

- It is also very likely that RW calibrations will need further adjustments (as mentioned above) and BCBS's forthcoming Quantitative Impact Study may make this clearer.

- The consultative document rightly notes that country risk may still be a relevant credit threat for banks, and thus another risk driver to reflect it may be possible in a final version. We expect this driver to emerge as an outcome of the BCBS's future work on sovereign-related risks in general.

- A challenge exists also with respect to the RWs of banks which are not subject to Basel 3 disclosure standards. For example, the document notes that "the CET1 metric in [non-Basel 3] jurisdictions, even if externally audited, would not be supervised by the relevant authority". We expect further clarification in this respect as well, especially since it is likely that various national supervisors will be reluctant even for RW calculations to submit their smaller banks to the Basel standards.

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