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INTERNATIONAL BANKING

Expert Analysis

Revised Proposed Changes To Capital Requirements

In my January 2015 column,[1] I discussed December 2014 proposed revisions to the international risk-based capital requirements using the Standardized Approach. The proposed revisions were issued by the Basel Committee, which develops international capital standards. After review of the comments and analysis of a quantitative study regarding the impact of the proposal on affected institutions, the Basel Committee issued a re-proposal of the changes for comment on Dec. 10, 2015.[2] Comments are due by March 21, 2016. This month's column will discuss highlights of the re-proposal.

Original Proposal

Under current Basel III capital standards, certain large banking organizations, with regulatory approval, can use their sophisticated internal risk-based models to determine the risk weight of their assets, called the Internal Ratings-Based Approach. The remaining banking organizations use the Standardized Approach. The standardized risk-based capital calculations as amended over the years are derived from the original risk-based capital standards issued in 1988.

The 2014 proposal and its December 2015 re-proposal represent one step by international banking regulators in a process to improve the consistency and comparability in banks' capital ratios by addressing what they see as excessive variability in risk-weighted asset calculations by banks using the authorized methods of calculating their risk-based capital.[3]

In December 2014, the Basel Committee also proposed that banking organizations approved to utilize the Internal Ratings-Based Approach be required to comply with a requirement that would set a permanent minimum capital floor below which a banking organization could not go in assigning risk weight to an asset, regardless of what its own internal models determined.[4] There had been a transitional capital floor for banks moving from using the Standardized Approach of Basel I to their own internal ratings-based risk models; the re-proposal would set a permanent capital floor.

Banking organizations using the Internal Ratings-Based approach must keep in mind that once fully implemented, the Standardized Approach

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will become the floor below which they may not fall, so the continued relevance of the Standardized Approach to Internal Ratings-Based users is apparent. The comment period for the capital floor proposal was March 27, 2015, but the capital floor proposal will be finalized in conjunction with finalization of the revisions to the Standardized Approach proposal.

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Why the Need for Change?

The stated objective of both the original proposal and the re-proposal is to ensure that risk-based capital requirements indeed reflect the riskiness of exposures, and that the Standardized Approach constitutes a suitable alternative and complement to the Internal Ratings-Based Approach used by large internationally active banking organizations.

In developing the re-proposal, the Basel Committee reviewed the comments as well as analyzed the results of an initial quantitative impact study it undertook to gather data on the potential impact of the proposal on affected banking organizations.

Reliance on Credit Ratings

A critical element in the original proposal was to have banking organizations move away from automatically relying on external credit ratings when evaluating an asset's creditworthiness. The U.S. banking regulators in their joint Dec. 22, 2014, press release on the first proposal noted that the proposed elimination of the use of external credit ratings was a key objective of the paper and encouraged comments on proposed alternatives to use of external credit ratings.[5]

In response to the comments, this re-proposal reintroduces the use of external credit ratings with respect to exposures to banks and corporate entities, as discussed further below, but also includes alternative approaches for jurisdictions that do not permit use of external credit ratings.

The United States is one of the jurisdictions that no longer permits use of external credit ratings. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010[6] eliminated the ability of several federal government agencies to utilize external credit ratings, including the federal banking agencies (the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC) and the Federal Reserve Board), and required them to substitute alternative standards of creditworthiness.

In 2012, the OCC finalized a revision of its regulations on permissible investment securities for national banks. The references to external credit ratings were removed and replaced with a requirement for banks to make their own assessment of a security's creditworthiness to determine if it is "investment grade," which is defined as "the issuer of a security [having] an adequate capacity to meet financial commitments under the security for the projected life of the asset or exposure. An issuer has an adequate capacity to meet financial commitments if the risk of default by the obligor is low and the full and timely repayment of principal and interest is expected."[7] In addition, in October 2013, the Federal Reserve Board, FDIC and OCC issued a revision of their interagency agreement on classification of securities to reference alternative standards of creditworthiness.[8]

Comparison

Some of the most significant provisions in the 2014 proposal related to exposure to bank and other corporate counterparties, and to real estate exposure.

Credit Exposure to a Bank. In the original proposal, the risk weights of credit exposure to a bank would be based on a table of risk weights based on the counterparty bank's capital adequacy ratio (a bank's common equity Tier 1 risk-based capital ratio) and its asset quality ratio (its net non-performing assets ratio).

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The re-proposal sets out alternatives depending upon whether the relevant jurisdiction allows use of external credit ratings. For those banks permitted to use the external credit ratings, the bank would first determine a "base" risk weight (20 percent to 150 percent) based on the external credit rating of the counterparty or the exposure set forth in a look-up table, and then through due diligence confirm that the rating "appropriately and conservatively" reflects the credit risk exposure to the bank counterparty. If due diligence reveals that a higher risk weight is more accurate, then the bank must raise the risk weight. However, even if the due diligence shows that a lower risk weight could be applied, the bank can go no lower than the base risk weight.

For jurisdictions that do not allow use of external credit ratings and for unrated exposures in jurisdictions that do allow use of external credit ratings, the Basel Committee is proposing a Standardized Credit Risk Assessment Approach, or SCRA. Under SCRA, banks would assess the credit risk of an exposure to a bank counterparty and slot it into one of three classifications (A,B,C), depending on various factors, including risk of repayment, capacity to repay regardless of external economic or business conditions and compliance with applicable regulatory capital standards.

Risk weights would run from 50 percent to 150 percent depending on both the bank's classification of its exposure to its bank counterparty and qualification for that grade as set forth in the definitions. A bank can move an exposure to a higher classification but cannot move it to a category lower than the one in which it was originally classified.

Credit Exposures to Corporations and Other Businesses. In the original proposal, the risk weights of credit exposures to corporations and other businesses (not individuals) would be based on a table of risk weights based on the company's revenue (the most common measure of earnings strength) and leverage (measured as total assets to total equity in accordance with applicable accounting standards).

As with the credit exposures to banks, the Basel Committee has proposed two alternatives depending on whether the jurisdiction permits use of external credit ratings. For banks incorporated in jurisdictions that allow the use of external ratings for regulatory purposes, similar to bank exposures, the lending bank would determine the exposure's "base" risk weight (20 percent to 100 percent) according to a look-up table based on external credit ratings. If due diligence indicated that a higher risk weight was warranted, then the bank would apply a higher risk weight. For unrated corporate exposures, the current 100 percent risk weight would be applied.

For banks in jurisdictions that do not allow the use of external ratings for regulatory purposes, risk weights would vary from 75 percent to 100 percent depending on whether it met certain investment grade criteria such as the ability to make repayment in a timely manner regardless of external business conditions.

In the original proposal, the risk weights of credit exposure in connection with certain specialized lending (project finance, object finance, commodities finance, income-producing residential and commercial real estate and land acquisition, development and construction) would be based on the higher of (i) the risk weight of the counterparty and (ii) 120 percent to all specialized lending exposures except with respect to land acquisition, development and construction finance, which would be 150 percent.

In the re-proposal, there are three categories: project finance, object finance and commodities finance. If external credit ratings can be used, the risk weight would be determined by the same risk-weight look-up table as for regular corporate exposures. If external credit ratings cannot be used, then a flat risk weight of 120 percent would be applied to object and commodity finance exposures, and a 100-150 percent risk range would be used for project finance exposures, depending on whether it is the pre-operational (150 percent) or operational (100 percent) phase of the project.

> Under the Standardized Credit Risk Assessment Approach, banks would assess the credit risk of an exposure to a bank counterparty and slot it into one of three classifications, depending on various factors, including risk of repayment, capacity to repay regardless of external economic or business conditions and compliance with applicable regulatory capital standards.

Real Estate Exposure. In the original proposal, there were three categories of real estate loans: residential, commercial and land acquisition, development and construction finance (ADC). The latter lending type had been part of the specialized lending category discussed above. In the re-proposal, all real estate-related exposures, including specialized lending exposures, will be categorized in the same asset class, with higher risk weights assigned when repayment is materially dependent on cash flows generated by the property collateralizing the loan.

• Residential Real Estate Exposure. Originally, risk weights for residential real estate exposures (ranging from 25 percent to 150 percent) would be determined on the basis of two risk drivers: loan-to-value and debt service coverage ratios (the borrower's ability to make the mortgage payments). In the re-proposal, the debt service coverage ratio driver is dropped, but the loan-to-value ratio is maintained. Risk weight would be determined based on a variety of factors, including loan to value ratio, debtor's ability to repay the loan, and quality of the collateral. In addition, a higher risk weight would be assigned if repayment was materially dependent on cash flow from the real estate collateral.

• Commercial Real Estate Exposure. Originally, the risk weights of commercial real estate exposures would be determined in connection with two options: the first, by treating them as unsecured loans to the counterparty (ranging from 60 percent to 300 percent), with countries implementing the changes having the discretion to set a more preferential risk weight of 50 percent if certain strict conditions are met; and second, determining the risk weight based on the loan-to-value ratio (ranging from 75 percent to 120 percent).

In the revised proposal, commercial real estate exposure risk weights (60 percent to 150 percent) would be determined using criteria similar to that for residential real estate exposure risk weighting (i.e., using loan to value ratios), with a higher risk weight for exposures when repayment is dependent upon cash flow from lease or rental payments from the collateral.

• **ADC.** ADC loans would remain at 150 percent risk weight consistent with the original proposal.

In addition to reviewing any comments that may be submitted, the Basel Committee also will be conducting another quantitative impact study to collect data regarding the impact of this re-proposal on the current allocation of exposures to risk-weight categories under the existing and revised Standardized Approaches.

Conclusion

This re-proposal is another chance for internationally active banking organizations to review and provide comments to the Basel Committee. As noted above, the re-proposal should be of relevance to banking organizations using the Internal Ratings-Based Approach because these changes to the Standardized Approach will at a minimum affect the finalization of the new capital floor with which they will be required to comply. As a result, all banking organizations may want to analyze the practical effect of the re-proposed Standardized Approach risk weights on their exposures before they are imposed by law or regulation in their home country jurisdictions and other jurisdictions in which they conduct banking operations.

1. "Basel Committee Proposes Changes to Standardized Approach Capital Rules," New York Law Journal, Jan. 14, 2015.
2. See Basel Committee on Banking Supervision, "Second consultative document—Revisions to the Standardised Approach for credit risk," December 2015, which can be accessed at http://www.bis.org/bcbs/publ/d347.pdf.
3. See Basel Committee on Banking Supervision, Reducing excessive variability in banks' regulatory capital ratios: A Report to the G20, November 2014, which can be accessed at http://www.bis.org/bcbs/publ/d298.pdf.
4. Basel Committee on Banking Supervision, "Consultative Document: Capital floors: the design of a framework based on standardised approaches," which can be accessed at http://www.bis.org/bcbs/publ/d306.pdf.
5. See Banking Agencies' Statement Regarding The Basel Committee's Consultative Paper, "Revisions to the Standardized Approach for Credit Risk," Dec. 22, 2014, which can be accessed at http://www.federalreserve.gov/newsevents/press/bcreg/20141222a.htm
6. See Pub. L. 111– 203, July 21, 2010, Sections 939 and 939A.
7. See 12 C.F.R. §1.2(d).
8. "Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions," Oct. 29, 2013, which can be accessed at https://www.fdic.gov/news/news/financial/2013/fil13051a.pdf.

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