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Financial Services Risk and Regulation

FSRR Briefing

Is this Basel IV?

Through 2014 BCBS consulted on revisions to the standardised approach to credit, counterparty credit, and operational risk. This is in addition to a consultation on standardised capital floors and the fundamental review of the trading book

In 2014 the Basel Committee on Banking Supervision (BCBS) consulted on five revisions to Pillar 1 of the Basel III framework and clearly had the standardised approach in its sights. It proposed revisions to the standardised approach to credit, counterparty credit, and operational risk. This is in addition to its consultation on standardised capital floors and the fundamental review of the trading book. Each consultation is significant in its own right, but considered as a whole, they represent a substantial revision to the regulatory capital framework. It appears as if the Committee is already working on replacing today's Basel III implementation projects with tomorrow's regulation and we see these consultations as setting the foundations for Basel IV. This note summarises each of the proposals and offers initial thoughts on the consequences. The date for submitting comments to open consultations is formatted in **bold**.

BCBS overhauls credit risk requirements

BCBS proposed revising the *Credit Risk Standardised Approach* on 22 December 2014. The proposals are wide ranging and may require banks to hold more capital. BCBS wants to reduce the role of credit rating agencies (CRAs) in determining capital requirements, instead requiring banks to examine their counterparty's financial circumstances to determine the riskiness of exposures themselves.

For interbank exposures, BCBS proposes forbidding banks from basing their risk-weights on CRA ratings, suggesting they consider the counterparty's capital adequacy and asset quality. Similarly for corporate exposures it proposes forbidding banks from basing their risk-weights on CRA ratings, suggesting they consider the corporate entity's revenue and leverage. It also proposes:

- tightening the criteria for banks to apply a 75% risk-weight to retail exposures
- abolishing the 35% risk-weight for residential mortgages, replacing it with a risk-weight proportionate to the original loan-to-value ratio and the borrower's loan-to-income ratio
- two new options for commercial mortgage risk-weighting
- reducing the number of approaches to credit risk mitigation, including updating the corporate guarantor eligibility criteria.

The credit risk of exposures to sovereigns, central banks and public sector entities is excluded from the revisions as it will be the subject of a separate consultation. BCBS is likely to do away with the 0% risk-weight under the standardised approach.

The proposed method for calculating interbank exposure risk-weighted assets (RWAs) could increase procyclicality. For example, banks X and Y are exposed to bank Z. A decrease in bank Z's capital ratio would increase the RWAs of bank X and Y, thereby reducing their capital ratios. If bank Z is exposed to X or Y it will experience another decrease in its capital ratio. Currently, a CRA will consider a bank's capital position in its credit assessment as one of many inputs. The proposals remove these additional inputs which makes the link between bank X, Y, and Z's capital positions more direct and accentuated. Increased cyclicality of credit risk has the potential to create systemic financial instability which opposes BCBS' core intentions.

Under the proposals, banks will need to use revenue and leverage to determine the risk weight for exposures to corporates and capital adequacy for other financial institutions. For unrated corporates and institutions this will add a welcome measure of risk sensitivity. But for those with a CRA rating the proposals could remove a number of quantitative and qualitative factors that are key to the credit risk assessment, potentially reducing the risk sensitivity of the measure.

Asking banks to determine their interbank RWAs on financial positions requires up to date and good quality data which assumes it is both available and accessible. But the BCBS proposal leans more on regular Pillar 3 disclosures. The Committee published its final standards for enhanced Pillar 3 disclosure requirements on 29 January 2015, with revisions designed to enable market participants to compare banks' disclosed RWAs and assess a bank's overall capital adequacy. Bank need to publish their first Pillar 3 report under the revised framework with their year-end 2016 financial reports.

The credit risk consultation closes **27 March 2015.** BCBS plans to run a Quantitative Impact Study (QIS) to further develop its proposals but has not indicated an implementation date.

Ramping up operational risk

BCBS proposed a major overhaul of operational risk measurement in *Revisions to the simpler approaches* on 6 October 2014. It identified that banks using the standardised and basic approaches underestimated losses by as much as 50%, so it developed a new measure.

BCBS suggests replacing the net income input with a new metric called the 'business indicator' (BI). The most significant change it proposes is for banks to use the absolute values of components, e.g. gross interest income, to determine BI. The bank would then multiply its BI by a coefficient to determine the overall operational risk charge for the year. Its capital requirement would remain the average of the past three years' operational risk charges.

The Committee does not want past losses to reduce a firm's capital requirement. Banks held less operational risk capital in the period 2010-12 despite facing an increase in operational losses. The BI is composed of absolute values rather than net income figures to include past losses in setting future capital. This new BI calculation is particularly relevant to the treatment of trading book profit and loss.

BCBS identified a non-linear relationship between operational losses and bank size, with larger banks facing proportionately larger losses. To address this, it proposes a progressive weighting system that varies the risk charge depending on bank size. The banks with the largest BI figure may have to apply a 30% coefficient. Banks with smaller BIs can apply a lower coefficient, down to the smallest banks which will need to apply a coefficient of 10%.

It's unclear whether the new BI measure is a better predictor of operational capital needs or just requires 'more'. The period BCBS used to back test the BI and alternative measures was characterised by rapidly increasing operational risk losses heavily biased towards litigation costs and fines. The litmus test will be whether the BI is accurate as operational losses fall.

The consultation period has closed. BCBS plans to publish finalised proposals in 2015.

Counterparty credit risk measure enhanced

The Committee revised the standardised method for calculating counterparty credit risk (CCR) in *The standardised approach for measuring counterparty credit risk exposures* issued on 31 March 2014. The new Standardised Approach (SA-CCR) calculation introduces significant changes to the methodology from the current non-internal model method approaches. Starting 1 January 2017, banks will use SA-CCR to calculate CCR exposure associated with OTC derivatives, exchange traded derivatives and long settlement transactions, replacing the Standardised Method, Current Exposure Method, or Internal Model Method (IMM) shortcut method. Firms that use the IMM to calculate their CCR will not be directly affected but will need to adopt in parallel the new standardised method for calculating capital floors. The SA-CCR feeds into both the capital requirements for bank exposures to central counterparties (that come into effect on 1 January 2017), and for measuring and controlling large exposures (which will take effect from 1 January 2019).

BCBS recognises that current standardised methods of calculating CCR exposure do not differentiate between transactions with and without margin capital, accurately reflect the volatility observed in recent stressed periods nor accurately recognise netting benefits. It claims the new SA-CCR is more risk sensitive, limits the need for discretion by national authorities, minimises the use of banks' internal estimates, and avoids undue complexity.

It calibrated the SA-CCR to reflect the level of volatility observed in the recent stress period and to encourage centralised clearing of derivative transactions.

The SA-CCR involves summing the replacement cost and potential future exposure and then multiplying by the BCBS set multiplier (currently 1.4) as used by IMM firms. The potential future exposure element includes a multiplier that allows for the partial recognition of excess collateral and an aggregate add-on. BCBS also provides methodologies for calculating the add-ons.

Slight tweaks to trading book review

BCBS consulted on the *outstanding issues in its fundamental review of the trading book* on 19 December 2014. It has revised its 2013 *market risk proposal* to address perceived weaknesses in banks' risk measurement under the internal models-based and standardised approaches. BCBS reviewed responses to the 2013 consultation, feedback from a hypothetical portfolio exercise, and the results of a comprehensive QIS conducted to assess the proposed trading book framework.

Based on these results it outlined three broad areas of the fundamental review to refine:

- treatment of internal risk transfers of equity and interest rate risks between the banking and trading books, to supplement the existing treatment of internal transfers of credit risk
- a revised standardised approach using changes in the value of an instrument based on sensitivity to underlying risk factors
- a simpler method for incorporating liquidity horizons in the internal models approach.

Responses from industry spurred BCBS into making these changes. In particular, removing the cash flow requirements in determining the standardised approach will help the industry which considered it a valuable concession in its favour. The consultation closes on **20 February 2015**.

Laying new capital floors

BCBS consulted on *capital floors: the design of a framework based on standardised approaches* on 22 December 2014. It proposed that banks use a capital floor based on revised standardised approaches for credit, market and operational risk to replace the floors from the Basel I framework. The Committee is considering three options: by risk type, exposure, or aggregate RWA.

The Committee wants to mitigate model risk and measurement error stemming from internally-modelled approaches. It feels the new floors would ensure that the level of capital across the banking system does not fall below an aggregate minimum and contribute to RWA consistency across institutions, so helping investors compare banks' capital ratios. The consultation closes **27 March 2015**, with the final standards planned for the end of 2015. This leaves little time for the industry to perform the required QIS and for both the Committee and banks to digest the results.

What's next?

In each area BCBS has proposed substantial changes. But viewed collectively the scale of the revisions is greater than the sum of its parts. In 2014 we may have witnessed the Committee laying foundations for Basel IV.

What do I need to do?

Firms need to act soon to prepare for the fundamental review of the trading book and the revised counterparty credit risk changes. We also expect to see the market risk proposals finalised by the end of 2015 with potential implementation in 2016. Firms should begin considering the changes they need to make across all fronts. Firms will find that some of the changes pose strategic opportunities and challenges as the market evolves. Other changes may require long lead-times to implement, particularly areas where firms' systems have to be modified, new data sourced and managed and functions such as Risk and Finance to work closer together. Beginning to plan for these changes now will help ensure a smooth transition.

There is still some way to go before the credit and operational risk consultations become finalised, followed by a long route into binding regulation. Though firms may not need to implement these in the short term, the time to influence the policy is now. BCBS has signalled its intent to run a number of QISs which we can assist you with if you are participating. We can also help you to navigate through the complexity of all these proposals, perform a deep-dive review to assess the business impact and connect the dots to draw strategic optionalities for your firm.

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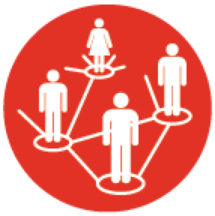

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