

## *Key points from Basel's re-proposed standardized approach for credit risk*

The Basel Committee on Banking Supervision (BCBS) on December 10<sup>th</sup> issued the second iteration of its proposed revisions to the standardized approach (SA) for credit risk measurement. Following up on last year's initial issuance, the proposed revisions are intended to amend BCBS's currently applicable SA in order to achieve a better balance between risk sensitivity, simplicity, and comparability.

While the latest proposal includes significant changes from last year's version in response to BCBS's quantitative impact study (QIS) and industry comments, several important issues remain. Most importantly, the revised proposal does not include an implementation timeline, and kicks the can down the road on the politically sensitive issue of refining risk weights for exposures to different sovereigns, central banks, and public sector entities. Addressing these remaining issues and other changes that may originate from the BCBS's upcoming QIS and further industry comments is likely to delay finalization for at least another year.

- 1. US implementation is a long way off.** While the proposal is intended to apply internationally to achieve consistency across jurisdictions, its implementation in the US remains unclear. The current Basel SA has just recently been finalized in the US.<sup>1</sup> Under the US final rule, banks with over \$500 million in assets must use the SA to calculate their regulatory capital, and Advanced Approaches<sup>2</sup> banks must use it to set their capital floor (as required under Dodd-Frank's "Collins Amendment"). US harmonization with the revised SA would require agreement among several US banking regulators, and is likely to attract significant industry push back, making US regulatory action unlikely until well after the BCBS standard is finalized.<sup>3</sup>
- 2. Capital requirements would increase for some banks.** Although BCBS has stated that the proposal's intent is not to increase overall capital requirements, the proposal nevertheless will for some credit exposures. These exposures include specialized lending, equity holdings, subordinated debt, and residential and commercial mortgages with high loan-to-value ratios.
- 3. The beginning of the end for internal models.** Despite their promise of better risk sensitivity, internal models have attracted criticism in recent years due to their tendency to generate varied, non-comparable results across internationally active banks. The revised SA aims to strike a balance by addressing this comparability issue, while improving upon the current SA's risk-sensitivity. As a result, the revised SA is a strong candidate to replace the internal ratings-based approach, especially when coupled with other tools to ensure capital adequacy, such as stress testing.<sup>4</sup> Therefore, we believe it is likely that internal models will be phased-out over time,<sup>5</sup> especially if the revised SA proves to be the binding capital constraint for banks through the introduction of a capital floor at the international level (similar to Dodd-Frank's floor).

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4. **The revised SA would improve comparability across banks, but only to an extent.** Although the revised SA would improve comparability across US banks, certain revisions would make comparisons between US and non-US banks more difficult. Namely, the proposal allows the use of external ratings to assess credit risk, which is prohibited for US banks under Dodd-Frank. This could lead to significantly different risk assessments; for example, the lowest risk weighting for investment-grade corporate counterparties using external credit ratings is 20%, compared to 75% using internal credit ratings.
  5. **Credit card and retail commitment businesses will be negatively impacted.** While retail lenders gain some benefits from the revised SA, those in credit card and retail-related commitment (e.g., home equity lending) businesses will likely be negatively impacted. The revised proposal includes a credit conversion factor (i.e., risk weighting) of 10 to 20 percent for these exposures, which is a significant jump from the current zero percent weighting (and an increase from initial proposal's 10 percent). This change is perhaps due to the latest QIS results which indicated that the average credit conversion factor estimated under internal models was higher than the originally proposed 10 percent.

## What's next?

Despite delivering significant changes from last year's proposal, BCBS's work on the revised SA is far from over, and will continue with another round of industry comments and an additional QIS in early 2016. Other cornerstones of BCBS's capital regime (e.g., market risk capital, operational risk capital, leverage ratio, and capital floors) also remain moving targets, further complicating banks' capital planning efforts. BCBS will release the next versions of its market risk and operational risk proposals early next year.

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## Endnotes

1. See PwC's *Regulatory brief, Basel III capital rules finalized by Federal Reserve: But much more to come for the big banks* (July 2013).
2. Advanced Approaches banks are generally those with more than \$250 billion in assets or \$10 billion in cross border activity. Given that the SA serves as a capital floor for these banks under Dodd-Frank, the point of retaining Advanced Approaches capital calculation methodologies has been questioned.
3. Furthermore, a new US rule would have to consider including BCBS's suggested application of the SA to banks with less than \$250 billion in assets. However, given the revised SA's compliance challenges (e.g., due to increased granularity of data), it is highly unlikely that the US will apply it to smaller institutions (e.g., those with only \$50 billion in assets).
4. See PwC's *First take, Fed's proposed amendments to the capital plan and stress test rules* (July 23, 2015).
5. See PwC's *Regulatory brief, Operational risk capital: Nowhere to hide* (November 2014), where we first made this suggestion.

## *Additional information*

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