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Basel IV, Changing the Regulatory Landscape of Banks

Introduction

Over the last decades, risk management in the banking industry has experienced substantial developments, especially with regards to increased regulatory pressures. In 1988, the first Basel Accord was introduced. Now, nearly 30 years later, in a set of papers published by the Basel Committee, the outlines of what has already been coined Basel IV become visible. When looking at the time period between 1988 and 2015 with regards to Basel regulation, what trends appear? What will be the main underpinnings of Basel IV? How will Basel IV impact the banking industry moments after Basel III, the Global Financial Crisis and the Asset Quality Review? These questions we answer in this paper.

BASEL DEVELOPMENTS SO FAR

In this section, we will give a short overview of different versions of the Basel Accord over the years. Basel I focused on simple metrics and comparability but lacked risk-sensitivity. Basel II, on the other hand, due to newly available statistical and mathematical modeling techniques, allowed for more complex and risk-sensitive models. Basel III raised capital requirements, placed more emphasis on liquidity management and introduced the non-risk based leverage ratio.

Basel over the years

Does a bank have sufficient capital to meet potential losses? This question is fundamental to assess the soundness and resilience of banks and was the central question behind the development of the first Basel agreement.[1] This Accord, defined in 1988, served, according to the Basel Committee on Banking Supervision ("BCBS"), a threefold purpose:

1. To make sure the amount of capital banks held was sufficient to cover their level of respective risk.
2. To level the playing field for cross-border banking. Before the 1988 Basel Accord, capital standards and measures differed significantly between different jurisdictions.
3. To facilitate comparability of the capital positions of banks. Following from the second point, comparability of capital levels between banks was severely hampered due to different standards and measures. The 1988 Basel Accord sought to end this lack of comparability.

Basel I included a definition of eligible capital and a set of simple risk-weights. Notwithstanding the benefits of the Basel I Accord, the approach suffered from several drawbacks with the most notable being a sole focus on credit risk, i.e. the risk that a counterparty of a bank would default on its obligations. Although this narrow focus helped Basel I in maintaining simplicity, it also lead to an exclusion of several different types of risk such as liquidity risk, market risk and operational risk. In 1996, the original Basel I Accord was updated with a market risk component. The inclusion of the market risk component was especially noteworthy because for the first time the Basel framework allowed for the development of internal models.

> "Over the years, regulations drafted by the Basel Committee have shifted in focus from simplicity to risk-sensitivity, albeit at the cost of decreased comparability."

The Basel II package, introduced in 2004, offered a number of changes compared to Basel I. The most noteworthy changes were:

1. Inspired by an upsurge in available statistical and mathematical modeling techniques, Basel II allowed for a greater reliance on internal model development by banks.
2. A capital requirement specifically for operational risk was introduced.
3. The supervisory review process and disclosure and market discipline principles were introduced.

Greater reliance on internal models developed by banks offered some significant advantages. Compared to the Standardized Approach, banks could, upon approval by regulators, use advanced internal models to develop a more precise estimate of required capital. Moreover, banks were rewarded for prudent and sound risk management practices as the capital requirements stemming from internal models were usually significantly lower than capital requirements under the Standardized Approach.

The Global Financial Crisis proved to be a wake-up call in terms of quantity and quality of banks' capital levels. The Basel III changes, introduced in 2010, offered some significant changes compared to Basel II including[2].

1. Minimum capital levels were increased.
2. The quality of capital was to be increased to make sure that capital was genuinely loss-absorbing.
3. The (non-risk based) leverage ratio was introduced.
4. The Liquidity Coverage Ratio was introduced.
5. The Net Stable Funding Ratio was introduced.

When focusing on the period between 1988 (introduction of Basel I) and 2013 (implementation of Basel III), a clear trend appears in terms of difficulty and transparency. Whereas Basel I was simple and transparent, Basel III is complex and non-transparent.

Finding the balance between Basel I, Basel II and Basel III

In retrospect, the pros and cons of different Basel Accords suggest that a careful balance needs to be sought between complexity and simplicity. Banks have different and advanced calculation methods at their disposal to assess the level of required capital by ever-increasing precision. Nevertheless, extensive reliance on internal models for the determination of capital levels coupled with a lack of transparency offers some distinct drawbacks.

One particularly important drawback is that market discipline is hampered, i.e., market participants should be able to gauge the riskiness of banks. Another drawback is that, with hundreds of internal models in circulation, senior management of banks may find it hard to judge and steer the level of risk of their respective bank. On the other hand, an overreliance on simplified measures lacks risk-sensitivity and does not capitalize on advances in statistics and mathematics

Simple measures lacking risk-sensitivity allow for the portraying of a high-risk position as low-risk. Therefore, ideally, new Basel regulations should offer the risk-sensitivity of Basel II and III, while striving for the simplicity of Basel I.

1. The regulatory framework: balancing risk-sensitivity, simplicity and comparability. Basel Committee on Banking Supervision. October 2013.

2. Eight progress report on adoption of the Basel regulatory framework. Basel Committee on Banking Supervision. April 2015.

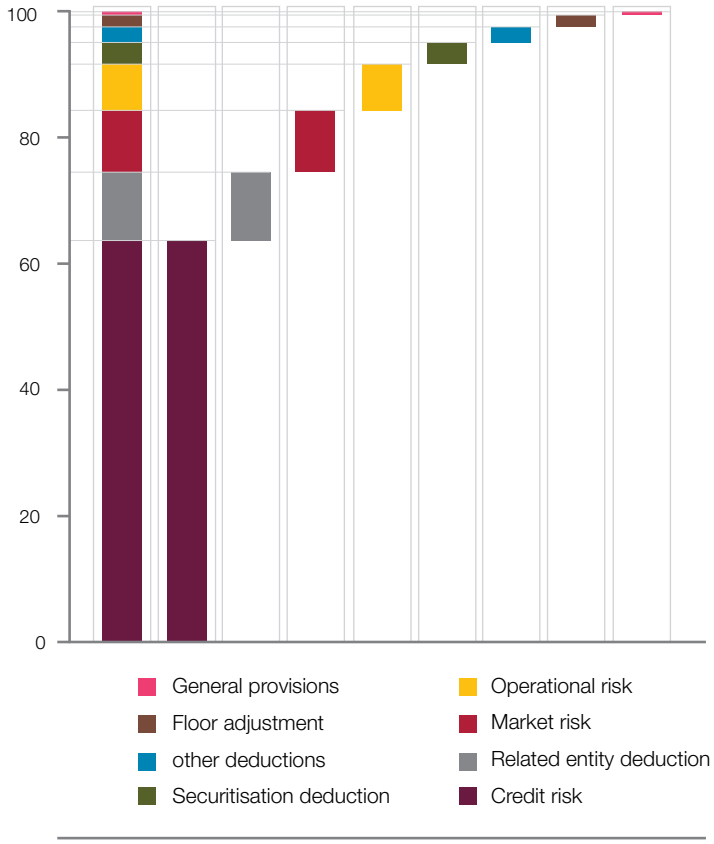
Learning from Basel III

In this section, we discuss a number of recent papers issued by the BCBS which voice concern regarding excessive variability in calculated capital by different banks for seemingly similar levels of risk. The lessons learned from Basel III have formed the foundation of a possible new Basel Accord.

Concerns on widespread differences in capital

Several recent papers issued by the BCBS highlight the issue of excessive variability in calculated capital for similar levels of risk. They focus primarily on market risk and credit risk. There is an obvious explanation for the emphasis on market risk[3 4] and especially credit risk[5] as they are the main contributors to Risk-weighted assets (RWA) (see figure 1).

Figure 1: Contributions to Risk-weighted assets[4]



> "Recent Basel studies investigate the calculation of capital levels by different large banks. Results indicate that banks calculate vastly different capital levels for seemingly similar levels of risk."

3. *Revisions to the Standardized Approach for Credit Risk. Basel Committee on Banking Supervision. January 2013.*

4. *Analysis of risk-weighted assets for credit risk in the banking book. Basel Committee on Banking Supervision. July 2013.*

5. *Analysis of risk-weighted assets for market risk. Basel Committee on Banking Supervision. January 2013.*

The recently published papers by the BCBS seek to answer two main questions:

1. Given two banks with a similar risk-appetite, how large are the differences in calculated RWA using the advanced IRB Approach?
2. How can it be explained that similar banks, in terms of risk, calculate different levels of RWA?

The answers on both questions are likely to be found in credit risk, as credit risk accounts for the majority of the observed dispersion in RWA according to the BCBS. Below, we will summarize the main points of the BCBS regarding credit risk with respect to the two questions posed above.

1. Capital ratios vary significantly, i.e. banks calculate significantly different levels of RWA for the same level of risk.
2. The ranking of riskiness of a set of borrowers is highly correlated between banks. In simple terms, this indicates that for a similar portfolio of borrowers ranging from very risky to nearly risk-free, two banks will have a large overlap in the set of borrowers classified as, for instance, very risky. Nevertheless, the absolute level of risk (e.g. the exact probability of default of a borrower) displays significant differences between banks.
3. The differences in Probability of Default (PD) and Loss Given Default (LGD) outcomes between banks for similar levels of risk are a main source of differences in RWA levels.
4. Six broad categories are identified by the BCBS as the most significant drivers of differences in RWA levels:
   a. The use of different credit risk approaches by banks.
   b. Different definitions of defaults used by banks.
   c. Different margins of conservatism added by banks to risk parameters.
   d. Differences in adjusting for cyclical effects.
   e. Issues in estimating risk parameters for low-default portfolios. This is an especially salient issue when estimating Loss Given Default (LGD) as, by definition, LGD is conditional on the occurrence of default.
   f. Different translations of external ratings to internal ratings.

Although the complete list of reasons for observed differences in calculated market Risk-weighted Assets (mRWA) between banks is too exhaustive to discuss here, we suffice by stating that different supervisory and modeling decisions severely impact mRWA.

Consequences for banks

As already stated in the paper of the BCBS regarding credit risk4, the BCBS is pondering on several policy implications in response to the observed differences in RWA levels between similar banks. Two policy implications are of crucial importance. First, the BCBS is investigating the possibility of requiring banks to disclose more information. This would allow external market participants to more precisely judge the riskiness of a bank. Banks should expect to be able to provide more detailed information regarding choices of credit-risk approaches, asset class mix, risk grade distributions and more in the near future. Second, the BCBS is investigating limiting the degrees of freedom of banks in applying their internal models when calculating capital levels. The implication of the last proposal could be severe: certain risk parameters could be restricted to not exceed a certain lower bound or be fixed at a certain value. The logic underlying such limitations on internal modeling approaches is clear: the more advanced the internal modeling approach, the greater the variability in RWA estimates. Nevertheless, care must be taken by the BCBS as the prospect of lower RWA levels under advanced Approaches compared to the Standardized Approach is a direct incentive for many banks to actively engage in financial risk management. In our view, fixing risk parameters (e.g. LGD levels) for certain portfolios can only be a complement to facilitate comparison of RWA levels between banks, but never a replacement of advanced and risk-sensitive LGD models.

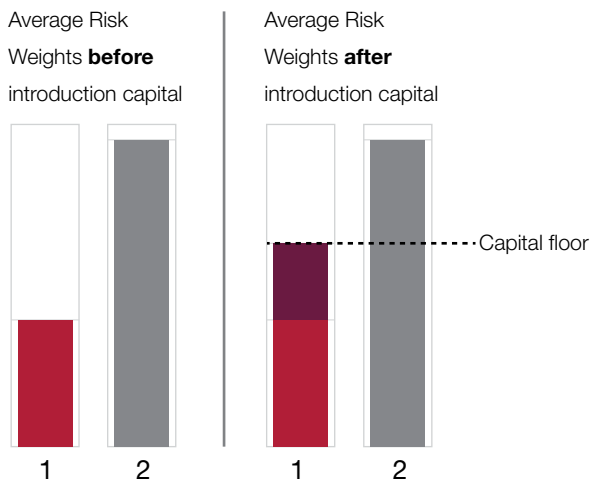
In a nutshell, recent papers by the BCBS signal a trend towards more simple and comparable risk metrics similar to Basel I.

A revised relationship between the Standardized Approach and Advanced IRB Approach

One of the proposed measures by the BCBS is to set a floor on advanced IRB calculated risk-weights. Figure 2 displays a hypothetical case involving two banks. Depicted are their risk-weights as calculated using the advanced IRB Approach[6]. The left part depicts the current situation and the right part displays the envisioned future situation as proposed by the BCBS.

As can be seen in figure 2 on the left side, bank 1 has a lower average calculated risk weight compared to bank 2. After introduction of a risk-weight floor, see the right part in figure 2, bank 1 has to collect additional capital to meet the risk-weighted floor imposed by the revised Standardized Approach. Bank 2, by comparison, has to use its own estimates in determining the level of capital required. The BCBS has suggested using risk-weights calculated by the revised Standardized Approach as the risk-weight floor.

Figure 2: Risk-weighted floors



> “Banks should expect: (1) enhanced Pillar 3 disclosures with an increased emphasis on timely, accurate and exhaustive risk reporting, and (2) new limitations with regards to internal models.”

6. In later sections we show that the capital floor is an output of the revised Standardized Approach. Here we assume the outcome is the same for both banks in our hypothetical example. This is plausible, as the revised Standardized Approach has been criticized for limited risk-sensitivity. However, for the sake of completeness, we note that under the Standardized Approach different banks could calculate different risk-weight floors.

A revision of the Standardized Approach

In this section we describe the suggestions made by the BCBS on the revised Standardized Approach. The revised Standardized Approach will assign risk-weights based on a small number of significant risk drivers. For each type of credit risk exposure, the risk drivers with the highest explanatory power are selected. Based on statistical results and expert knowledge, corresponding risk-weights are calculated. These risk-weights are summarized in a lookup table that banks can use to determine their regulatory capital. See table 1 for an overview of the suggested revisions to the Standardized Approach.

Table 1: Overview of suggested revisions to the Standardized Approach

Counterparty	Subcategory	Risk drivers	Risk-weights
Banks		CET1 ratio	See Table 2
		Net NPA ratio	
Corporates	Senior corporate	Revenue	See Table 3
		Leverage	
		Equity	
	Specialized lending		Project finance, object finance, commodities finance and income producing real estate exposures: Risk-weights > 120 %
			Land acquisition, development and construction exposures: Risk-weights > 150%
Securities firms and other financial institutions			Treated as Banks (conditional on criteria)
			Treated as Corporates
Multilateral development banks		External credit assessment	Depending on assessment
Retail			Preferential treatment (conditional on four criteria): Risk-weights = 75%
			Other retail exposures: Risk-weights = 300%
Subordinated debt, equity and other capital instruments	Equity holdings		Publicly traded on recognized exchange: Risk-weights = 300%
			Other equity: Risk-weights = 400%
	Subordinated debt and other capital instruments		Risk-weights = 200%
Claims secured by real estate	Residential real estate	Debt service coverage ratio	See Table 4
		Loan-to-value	
	Commercial real estate	Loan-to-value	
Off balance sheet items	Application of CCF dependent on classification		Risk-weight = 100%

Weaknesses of the current Standardized Approach

The BCBS recognizes a number of weaknesses in the current Standardized Approach:

- **Over-reliance on external credit ratings**

Even though credit rating agencies play an important role in determining and analyzing credit risk exposures, the BCBS claims that blindly relying on external assessments of risk will lead to non-prudent risk management of market participants. Furthermore, using external ratings is only viable if the corporate is in fact rated.

- **Lack of granularity and risk-sensitivity**

As it currently stands, the Standardized Approach lacks responsiveness to differences in risk. Moreover, the current Standardized Approach makes relatively crude distinctions in risk levels between different entities.

- **Out-of-date calibrations**

The risk-weights as described by the current Standardized Approach reflect a financial market that has since changed and evolved. The accuracy of the current estimates might no longer be relevant and a recalibration is required.

- **Different risk-weighting of similar exposures under different approaches**

There are exposures that are defined in the Standardized Approach and the Advanced IRB Approach but that receive different risk-weights under both approaches. According to the BCBS, the differences between the two approaches should be reduced.

- **Lack of clarity**

Definitions of exposure categories are currently overly complex. Furthermore, some exposures within the Standardized Approach require banks to include internally estimated models. This runs counter to the principles of the BCBS.

A tentative outlook on the revised Standardized Approach

The BCBS has defined a risk-weight estimation methodology for different counterparty exposures:

- **Exposures to banks**

In the current approach, bank exposures are analyzed by referencing external credit raters and assigning risk-weights based on these ratings. In the revised Approach, the BCBS suggests to use two risk drivers for the calculation of risk-weights for bank exposures. The first risk driver is Capital Adequacy which is evaluated by the CET1 ratio. The second risk driver is Asset Quality, measured by a bank's Non-Performing Assets ratio.

Table 2: Exposures to banks[3]

	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%	300%
1% < Net NPA ratio ≤ 3%	45%	60%	80%	100%	120%	
3% < Net NPA ratio	60%	80%	100%	120%	140%	

- **Exposures to corporates**

As with exposures to banks, the current Standardized Approach referenced external credit rating agencies for assigning risk-weights and the revised Standardized Approach determines risk-weights based on risk drivers. Two risk drivers have been determined to be capable of predicting corporate default while still preserving simplicity. These risk drivers are revenue and leverage.

Table 3: Exposures to corporates [3]

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

Table 3 shows the possible combinations of revenue and leverage and their corresponding risk-weights. A corporate with higher revenues and lower leverage will have a lower risk of default and therefore should receive a lower risk-weight. Note that negative equity is defined as a corporate with more liabilities than assets and is automatically assigned a risk-weight of 300%. Again, counterparties with missing revenue or leverage data receive a risk-weight of 300%.

- **Retail exposures**

A retail exposure that meets the regulatory retail criteria receives a risk-weight of 75%. Any individual that does not meet all criteria will not be eligible for a preferential risk-weight and will receive a risk-weight of 100%. Currently, the BCBS is considering other approaches to increase risk-sensitivity.

- **Exposures secured by residential real estate**

Currently, exposures secured by residential real estate automatically receive a flat 35% risk-weight. In the revised Approach this would no longer be the case. Instead, the BCBS proposes a model based on two risk drivers. The first risk driver is the loan-to-value ratio.

Experience has shown that the lower the outstanding loan amount relative to the value of the residential real estate collateral, the lower the loss incurred in the event of a default. The second risk driver, Debt-Service Coverage (DSC) ratio, is a measure of a borrower's ability to service its current debts. The aforementioned could have drastic consequences for the housing market. For instance, banks might become unwilling to provide a loan covering the entire house price.

Table 4: Exposures to banks[3]

	LTV < 40%	40% ≤ LTV < 60%	60% ≤ LTV < 80%	80% ≤ LTV < 90%	90% ≤ LTV < 100%	LTV ≥ 100%
Loans to individuals with DSC ≤ 35%	25%	30%	40%	50%	60%	80%
Other loans	30%	40%	50%	70%	80%	100%

Table 4 displays the suggested risk-weights for the corresponding LTV and DSC ratios. For example: an individual with a DSC ratio of 25% and a LTV ratio of 85% would receive a risk-weight of 50%. Note that these risk-weights should be applied to the full exposure amount.

- **Exposures secured by commercial real estate**

Exposures secured by commercial real estate are subject to further consideration. Two options are currently envisaged: (1) treating them as unsecured exposures; or (2) determining the risk-weight according to a look up table where risk-weights range from 75% to 120% based on the loan-to-value ratio.

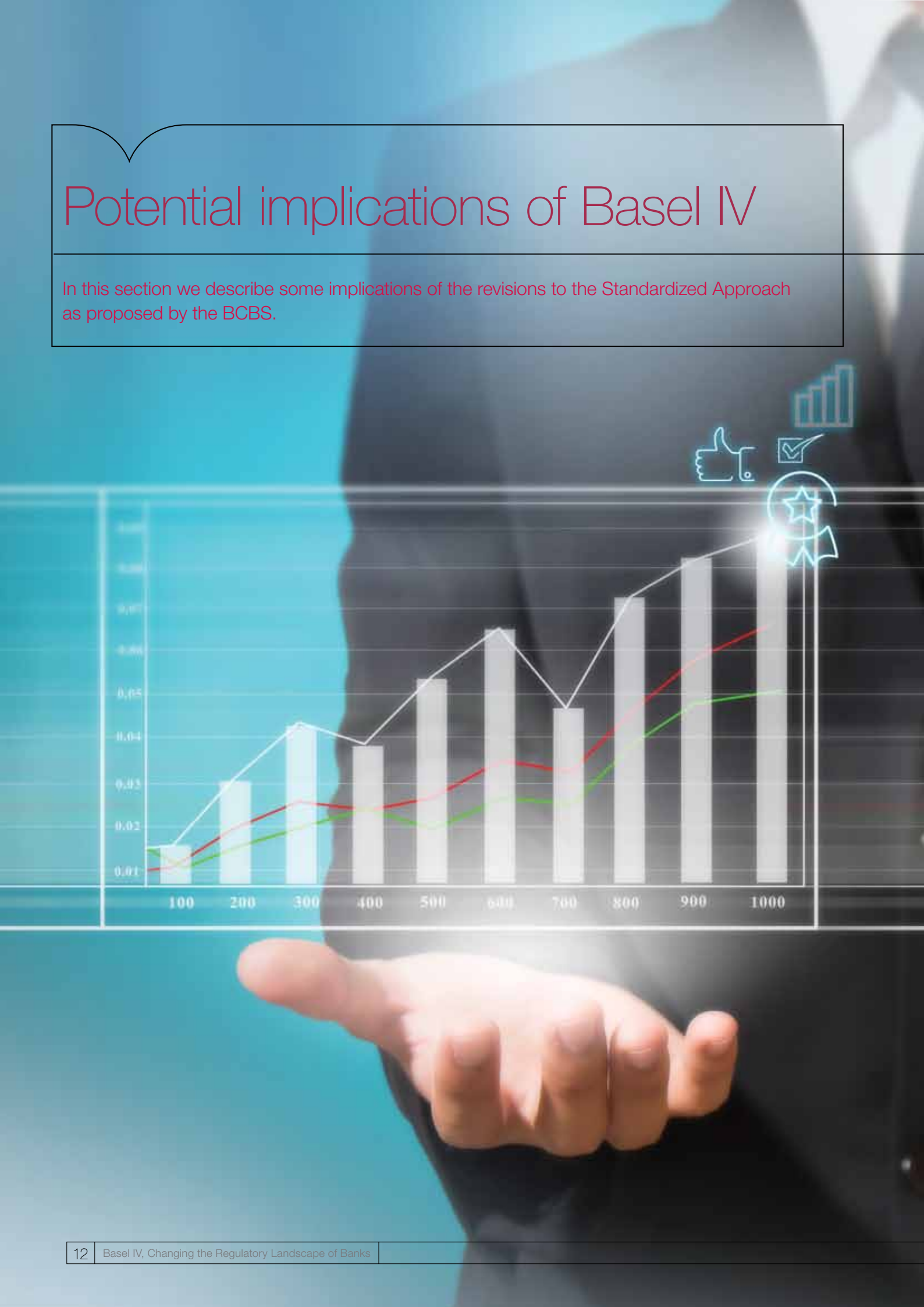
For exposures secured by commercial real estate, Table 5 shows the envisioned look up table for risk-weights. These risk-weights are determined exclusively by the loan-to-value ratio. An asset with a loan-to-value ratio of 65% would, for example, receive a risk-weight of 100%.

Table 5: Exposures secured by commercial real estate[3]

	LTV < 60%	60% ≤ LTV < 75%	LTV ≥ 75%
Exposures secured by commercial real estate	75%	100%	120%

Potential implications of Basel IV

In this section we describe some implications of the revisions to the Standardized Approach as proposed by the BCBS.



> “Recent Basel studies investigate the calculation of capital levels by different large banks. Results indicate that banks calculate vastly different capital levels for seemingly similar levels of risk.”

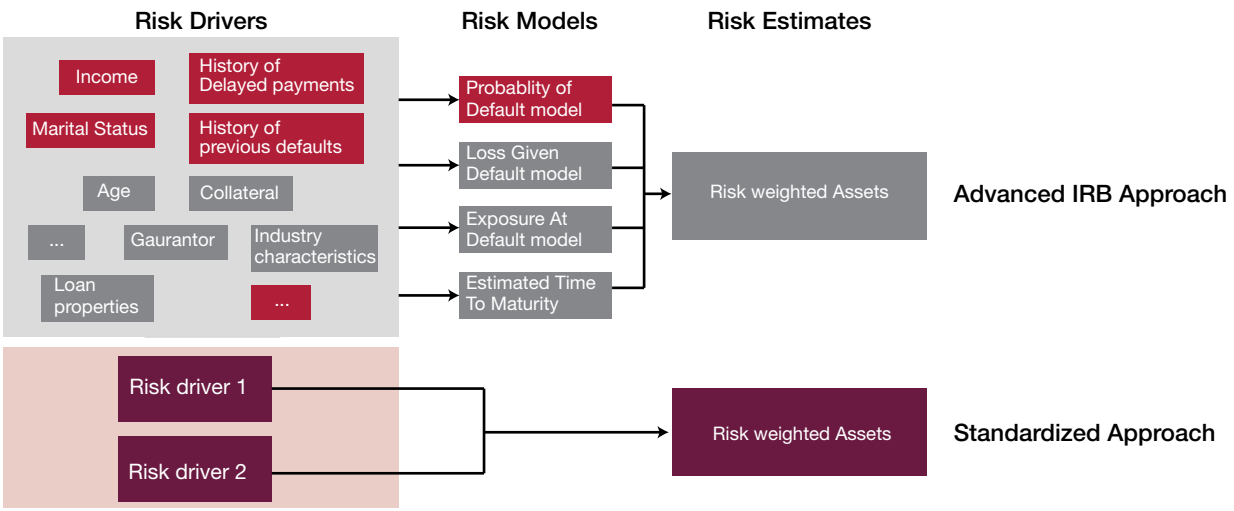
Decreased reliance on complex internal models

Basel II, and its increased reliance on internal models, fuelled modeling efforts of banks. Indeed, most large banks currently possess vast modeling departments. These banks simultaneously manage hundreds of different models. For instance, banks develop Probability of Default, Loss Given Default, Exposure at Default, Economic Capital and Risk-weighted Assets models. In return for their investment in sound risk management practices, banks are rewarded with an on average lower level of calculated RWA than under the more general Standardized Approach. However, the outlines of Basel IV seem to suggest that reliance on complex internal models will decline.

This decline is spurred by excessive variability in calculated RWA levels for similar levels of risk across banks. The impact of a more prominent role for the Standardized Approach can be severe. As a positive effect, risk levels of banks will be more transparent and easier to compare. However, the future dominance of the Standardized Approach may provide a disincentive for banks to develop advanced, risk-sensitive internal models. The more prominent role for a Standardized Approach will likely take shape in the form of floors on outputs from internal models.

For instance, the Standardized Approach may impose a floor whereby the LGD estimate cannot be lower than 10% for a particular portfolio. Overall, the BCBS seems to suggest a separation of goals between advanced, risk-sensitive internal models and the Standardized Approach. Whereby the former may more prominently be used for internal risk management purposes and pricing, the latter may become the de facto standard for regulatory reporting.

Figure 4: A-IRB versus proposed new Standardized Approach



> “We expect a decreased emphasis on advanced modeling techniques and increased data requirements and risk transparency.”

As can be seen in figure 4, under the A-IRB Approach, banks are, to a large extent, free to estimate their models based on available predictors. As shown in figure 4, in this case, the bank estimates a PD model based on income, history of delayed payments, marital status, history of previous defaults, age and possibly some other predictors. The PD estimates are then used in another model to estimate the RWA level

In comparison, under the new proposed Standardized Approach the RWA level is directly estimated based on two predetermined risk drivers. We expect that the new Standardized Approach will lack risk-sensitivity. Results of internal, risk-sensitive models and the more general, but not risk-sensitive, Standardized Approach will likely differ. We see challenges ahead for banks when analyzing and discussing the discrepancies with regulators.

Standardized, but more extensive data collection and reporting

In the aftermath of the Global Financial Crisis, the pressure on banks to supply external parties with accurate and timely information regarding their riskiness has increased. Nevertheless, in practice, there is considerable heterogeneity in what banks report to external parties. First, banks often

use different definitions for the same concept. Second, the level of risk is presented in different ways. Third, the level of detail in risk reporting differs considerably. All these factors contribute to the murkiness of accurately assessing risk taking of banks. In response, the BCBS seems to steer towards more standardized and more detailed risk reporting and data collection. In that sense, we expect Basel IV to place increased pressure on banks to gather accurate and detailed information on their counterparties to use in more standardized reporting. As became obvious during the Asset Quality Review, many banks lack sound data management. Based on recent papers by the BCBS, it is our contention that data management will become vastly more important in time (see also BCBS 239).

Changing customer selection criteria

The BCBS proposes that the new Standardized Approach will indicate limits on outputs from more advanced internal models. As a result, customer selection criteria may change. For instance, if a bank estimates that the RWA of a potential customer is below the calculated RWA threshold derived from the Standardized Approach, it may chose not to engage in business with that particular customer because the expected return does not compensate for the alleged increase in risk. A consequence of such a development may be that on average banks will increase the overall riskiness of their portfolios. As such, the BCBS should place more emphasis on investigating the (unwanted) side-effects of putting in place a non-risk sensitive floor on internal model outputs. Moreover, due to increasing risk weights, banks may be unwilling to provide a loan that covers the full house price to a borrower. As a result, new entrants to the mortgage market, not bound by the new Basel directives, may provide a borrower with the additional funding needed to cover the full house price.

Increased transparency and detailed risk reporting

One of the significant changes in the proposed framework is the additional financial statement information required regarding counterparties and the significantly higher punitive risk-weight in case of missing information on counterparties. Under the current Standardized Approach, for example, an unrated corporate would receive a risk-weight of 100%. Conversely, under the proposed framework, a corporate without the required financial statement information would receive a risk-weight of 300%. Therefore, banks are penalized severely in case of missing information on counterparties.

Banks not subject to the Basel III standards would be requested by their creditor banks to calculate and disclose the CET1 and net NPA ratios in accordance with Basel III requirements, so as not to be subject to the highest risk-weight. While Basel III is primarily designed for internationally active banks, the proposed approach would mean that obligor banks would have to apply Basel III, both for the calculation of capital and the calculation of risk-weighted assets, even if they are not internationally active or if the national supervisor has not adopted Basel III. This could potentially be burdensome for banks not subject to Basel III standards, and would mean the CET1 metric in such jurisdictions, even if externally audited, would not be supervised by the relevant authority.

Changing roles of credit rating agencies

The risk assessments made by external credit rating agencies play a vital role in the current assignation of risk-weights to counterparties. A large portion of counterparties is, however, unrated, making risk differentiation difficult. In the revised Approach, external credit ratings will no longer be a fundamental part of calculating risk-weights. Instead of credit rating scores for regulatory purposes, external ratings will be a part of economic assessments where they will be used for customer selection and pricing. This could indicate that banks need to further develop internal capabilities regarding credit rating.

Increasing capital requirements for banks

The BCBS proposes to set values stemming from the new Standardized Approach as lower bounds on outputs from the A-IRB approach. As a direct consequence, capital requirements for banks might increase significantly. For instance, a bank might calculate a PD of 4% for a particular portfolio using the A-IRB approach. However, the new Standardized Approach might mandate a minimum PD value of 10% for that particular portfolio. As a result, that bank will be required to calculate RWA based on a PD of 10% instead of 4%, resulting in additional capital requirements.

Conclusion

New proposed revisions to the Standardized Approach will have consequences for the banking world. Basel I to III saw an increase in complexity and risk-sensitivity. New proposed revisions, already named Basel IV, attempt to: (1) increase the risk-sensitivity of the Standardized Approach; and (2) improve the comparability of outputs from the advanced IRB Approach. Risk-weights are no longer assigned on the basis of external ratings or simply a fixed percentage. Instead, risk-weights will be based on predetermined risk drivers that are claimed to be capable of explaining credit risk. We see the following consequences for banks if the proposed regulations become reality:

- A decreased reliance on internal models.
- Standardized, but more extensive data collection and risk reporting.
- A change in customer selection criteria.
- Increased transparency in risk reporting.
- A changing role of credit rating agencies.

Most importantly, the setting of lower bounds on outputs from the A-IRB approach has the potential to increase required capital levels for banks.

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