Standard & Poor’s official response to the Basel Committee’s proposal

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Abstract

The following text is Standard & Poor’s official response to the Basel Committee’s proposal, which was presented to the regulators in December 1999. Standard & Poor’s welcomes the opportunity to respond to the committee’s proposal. The risk adjustment of capital, introduced in a simplified format in the 1988 Basel accord, was adopted by most of the world’s bank regulatory regimes. The current proposal could meaningfully advance this process, a development that Standard & Poor’s strongly supports. © 2001 Standard & Poors. Published by Elsevier Science B.V.

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1. Executive summary

The proposal considers risk adjustment through three separate approaches: the use of credit ratings provided by external credit assessment providers, the ‘standard method’; the use of internal risk ranking systems used by sophisticated banks; and the use of credit portfolio modeling. Standard & Poor’s agrees with the sense of the proposal that while portfolio credit modeling is a promising technique for risk adjustment of capital and...
will ultimately play a significant role, it is not currently ready to be adopted as an effective, efficient tool. The use of a bank’s own internal scoring should be limited to banks that can demonstrate robust and appropriate internal risk scoring systems.

Standard & Poor’s believes that the discipline of a more rigorous risk adjustment process can be beneficial regardless of the source of risk assessments, and is applicable to both large banks with significant cross-border activities and smaller banks with less geographic and business diversification. The growing complexity and hence opacity of the risk profile of many large global institutions has already created an environment in which management, regulators and the analytical community must increasingly rely on the use or output of models to measure and track risk. Standard & Poor’s expects this trend to continue, accompanied by an increased focus on the model performance and on the internal risk assessments, assumptions or stress scenarios, which heavily determine a model’s output. The committee’s proposal both acknowledges and confirms this trend.

Standard & Poor’s believes that the management and regulatory disciplines inherent in the proposal would serve to accelerate the development of sound credit cultures and strong supervision that underpins a new global financial architecture. Our emerging market bank ratings distribution, the vulnerability these ratings suggest and the sizable contingent liability these banking systems represent to their respective sovereigns, all are evidence of this need. While some elements of the proposal are complex and may be more applicable to developed market banks, the fundamental concept of risk adjusting exposure for capital adequacy calculations is not.

Consequently, Standard & Poor’s would strongly support the committee’s moving forward with introducing a common framework of risk adjusting capital that would be broadly applicable in developing as well as developed markets banking systems.

Over the last several months, Standard & Poor’s has engaged market participants in discussions of the merits and implications of the discussion document and its multiple potential outcomes. We have commented periodically on these, particularly with respect to the positive implications of the proposal for the stability of the global financial system, and on the potential approaches to the risk adjustment process for bank capital measurement. Those comments, as well as our specific concerns about the implications of increased regulatory use of ratings, are included within this submission.

1.1. Background on Standard & Poor’s and its operations

Standard & Poor’s began its credit rating activities more than 80 years ago and today is a global leader in the fields of credit ratings and risk
analysis. Standard & Poor’s began its rating activities with the issuance of credit ratings on corporate and governmental debt issues. Since 1916, Standard & Poor’s has rated hundreds of thousands of issues of securities, corporate and governmental issues and structured financings. Responding to market developments and needs, Standard & Poor’s also assesses the credit quality of, and assigns credit ratings to, mutual funds and the ability of insurance companies to pay claims, and assigns market risk ratings to managed funds. Standard & Poor’s also rates sovereigns and currently rates 82 sovereign governments.

Today, Standard & Poor’s has ratings outstanding on more than 98,000 issues of securities of obligors in more than 100 countries. Standard & Poor’s rates and monitors developments pertaining to these securities and obligors from operations in 21 world financial centers. Standard & Poor’s is committed to quality ratings assigned on an impartial basis by independent rating committees comprised of analysts who are professionals with credit experience in their areas.

1.2. Key analytical points

The proposal is a positive step to better risk adjustment of capital in developed and developing markets. Standard & Poor’s believes that internal and external credit assessments are valid and complementary tools to determine risk capital:

1. Using internal assessments raises key issues: the integrity of different banks’ systems and regulators’ process and criteria for approving them; the need for third parties to review these systems so they are consistent or comparable, with the goal of developing a global standard; and the need for disclosure so regulators and other third parties understand the differences among methodologies and how they perform.

2. Using external credit assessments would provide transparency but raises important issues:

- The need to compare domestic scale ratings assigned by local and international rating agencies to avoid ‘rating shopping’ for the highest rating and to ensure quality ratings.
- The different approaches to rating local currency and foreign currency obligations suggest an issue-specific rating approach is best.
- Permitting unsolicited ratings would encourage more ratings to be determined without the issuer’s cooperation and input. Transparency could be compromised because, where used, the market is not often aware that ratings are unsolicited.
- Short-term ratings should be used together with long-term ratings. Any preferential weightings for short-term exposures should be carefully considered. They may only be appropriate for higher-rated entities. If
allowed, the preferential treatment should extend not only to banks but also to corporates and sovereigns.

- The committee should reconsider the different risk weightings proposed for equivalently rated entities in different industries. While the proposal is preferable to the existing OECD membership standard, preferential weightings can adversely distort the flow of funds, particularly with regard to sovereigns. This approach can have a negative effect on creditworthiness and, ultimately, on the ratings within the preferred sector.

- The proposal to allow national banking authorities to determine the weighting of local currency sovereign debt may introduce non-credit-related risk.

- The proposed risk weightings should be differentiated for the broad middle range of rated entities.

- The second option for assessing banks, that is, using ratings on individual banks but giving a 50% weighting to unrated banks, is more analytically sound. The first option implies that sovereigns would bail out their banks.

- The sharp differentiation in the treatment of securitized assets is appropriate.

1.3. Recognition of rating agencies

In addition to the analytical points, should the committee decide to use ratings provided by external rating agencies, either on a standalone basis or to calibrate banks’ internal rating systems, Standard & Poor’s believes further dialogue with the ratings industry should take place. We have concerns about the committee’s proposal to establish minimum criteria for bank supervisors in each country to implement to determine which rating agencies and ratings to approve for purposes of the proposal. These recognition criteria, as broadly worded and presented, are likely to lead to further substantive regulation of rating agencies and their operations. Such regulation and the ongoing intervention by regulators could undermine the ratings industry by putting the core principle of independence at risk. Agencies’ objectivity and credibility are also at stake. Regulation leads to conformity and changes the role of ratings from being valuable opinions on credit risk, to being a commodity in the market. Regulation leads to a shift in focus to wanting higher ratings rather than meaningful comparative analysis.

Rating agencies and the financial markets that use ratings are separate from banking regulators and serve separate roles. Regulators and rating agencies work independently to provide market discipline. For rating agencies to continue to best serve the global markets, we believe the committee should carefully consider the importance of this separation and the need for rating agencies’ continued independence.
2. Credit assessments and the risk adjustment process

2.1. Use of banks’ own internal ratings

Standard & Poor’s has identified several issues which would need further attention if external or the banks’ own credit assessments are utilized in some way in the risk adjustment process. Although both methodologies have shared and similar complexities, Standard & Poor’s generally regards these approaches as complementary for reasons described below.

Standard & Poor’s concurs with the sense of the proposal that the internal credit assessments of institutions with advanced credit management systems may serve as an appropriate basis for the risk adjustment process. Moreover, we believe that any processes that encourage banks to lend prudently and carefully monitor their portfolios are in the interest of a sound global financial architecture. The management, quality and, where disclosed, output of internal systems are incorporated into our bank rating process, and in recent years, into our analysis of bank CLOs and credit derivative structures.

Reliance on internal credit assessments would, however, raise three key issues: (1) the ongoing integrity of these systems; (2) the rigor and consistency of the regulatory or private sector review process by which such internal risk ranking systems are accredited for the risk adjustment process; (3) the introduction of new disclosure standards to enable market participants to compare both the theoretical basis and performance of disparate internal risk ranking methodologies and systems and the capital adequacy measurement such systems would support. These issues are similar to and even more challenging perhaps than those raised by incorporating a diverse set of external credit assessment providers.

Standard & Poor’s expects convergence among risk management best practices and, in particular, internal risk ranking systems albeit at a slow pace. This is evidenced in part, by an increasing trend by bank management, especially large global banks, to benchmark their existing risk ranking system to external ratings, often Standard & Poor’s. Such a mapping or benchmarking process occurs not only as a tool to evaluate or double check credit ratings assigned by bank personnel, but also within the context of the strategic balance sheet and credit management objectives of the bank. This benchmarking provides insight into the potential or expected credit performance of the loan bank in a way that can be readily communicated. It is generally intended to provide greater liquidity and more efficiency and transparency in support of more active balance sheet risk management, especially securitization and the use of derivatives. Basically, it translates the banks’ credit book into the common language of the capital markets: ratings. This trend among large US based institutions is documented by research by The Federal Reserve (Federal Reserve Bulletin, 1998). This trend
is not unique to large global institutions or US banks, but supported by the shifts underway in the financial intermediation process in many markets around the world.

Standard & Poor’s believes that the potential regulatory use of banks’ internal risk ratings and a more formulated approach to incorporating risk mitigation practices would create powerful incentives for bank management to seek the regulatory capital self-determination this implies, significantly raising demands on regulators to evaluate and accredit internal risk rating systems for use in the risk adjustment process. This regulatory process, supplemented by independent private sector third party accreditation of the internal risk rankings, will benefit industry credit risk management. Among other benefits, this approach may result in improved risk adjusted pricing, and exposure management, strengthened documentation standards and enhanced risk mitigation practices, policies and measurement.

However, there remains a risk that such reliance, based solely on local regulatory judgement and approval and not accompanied by strong disclosure, could diminish the market’s role. Moreover, the potential to influence such an adjustment process to achieve competitive advantage, both at the institution and at the country level, raises the importance and necessity of a consistent approach by bank regulators across countries and the need for a meaningful education and training program to support the effort. There is currently a significant disparity in the quality and rigor of bank credit risk management across countries and meaningful differences in the preparedness of bank supervisory functions to undertake the requirements implied by reliance on banks’ internal systems.

Standard & Poor’s believes a necessary underpinning is a commonly agreed global standard of assessing bank risk ranking systems and common disclosure standards. The absence of this framework may result in significant disparity of approaches by bank regulators across countries, with a potential to diminish the information content and integrity of regulatory capital ratios. This would effectively undo the laudable purpose of the Basel Committee’s original work.

In anticipation of a potential committee decision allowing reliance on internal risk ratings, Standard & Poor’s is expanding its information requirements and bank management discussions with respect to the policies, practices, and performance of banks’ internal ratings systems, and recommending a significant increase in the public disclosure regarding these systems. While Standard & Poor’s and ratings agencies in general can perform the meaningful, beneficial function of an external, independent, credit knowledgeable review of such systems, the absence of significant public disclosure of internal systems will raise the potential of a blackbox determination of capital adequacy with limited participation outside of banks’ management and their supervisors.
2.2. Use of external credit assessments

The use of external credit assessments or ratings in the risk-adjustment process is valid, given the many years of empirical data that some agencies have developed and the significant measured differences in default risk at different rating levels. The history and performance of ratings is publicly available and Standard & Poor’s has included as Exhibits 1 and 2 to this submission a database of ratings behavior, Standard & Poor’s CreditPro, and the most recent default study for the committee’s use.

The use of external credit assessments also provides for substantially greater transparency and comparability in the risk adjustment process, based especially on the extensive public disclosure of the criteria, methodology, process and actual credit decisions of Standard & Poor’s, and other agencies versus the banks. The benefits of external credit assessments are principally that they more closely approximate, or can be more readily adapted to serve as a common language of credit, that they are public and so are continuously subject to market scrutiny and its self-correcting disciplines, and that they are impartially determined.

Still, to the extent the committee intends, the standard approach and use of external credit assessments or internal bank risk rankings to provide a common basis for measurement and thus, comparable measures of capital adequacy across institutions and countries, the committee will need to reconcile the existing diverse set of policies, practices, and internal rating or ranking scales currently in use among the banks. The committee and markets will want to become more familiar with rating agencies’ diverse policies practices and rating scales, if external ratings are used. Standard & Poor’s is meeting with market participants on an ongoing basis to discuss our practices and procedures. We regularly conduct meetings around the world. It should be understood that ratings are opinions and not audits. Establishing the policies, methodologies and rating scales is best left to each rating agency given the experience required to produce credible ratings and the mix of objective and subjective analysis. Agencies should have an obligation to explain their criteria to the public. As the committee notes, methodologies should be free from political influence and economic pressures. Standard & Poor’s views on regulation are discussed in detail below.

2.2.1. Technical rating policy issues which need to be resolved

2.2.1.1. Globally comparable ratings and local or domestic scale ratings. While Standard & Poor’s recognizes the reasons the committee is considering the acceptance of agencies that operate in only one country, complexities arise from the inclusion of purely domestic rating scales. The rating scales used in a single country, including Standard & Poor’s, are intended to reflect relative
creditworthiness in a local context, rather than a globally comparable measure of default risk and are, therefore, not directly comparable with global opinions (see Exhibit 5 on local scale ratings). Domestic scale ratings must therefore be able to be interpreted with some kind of public concordance, so that international comparability is assured, and all users understand what different agencies’ ratings imply for risk weightings. This benchmarking is made more complex by the diversity of approaches upon which such local scales are based. The benchmarking is nonetheless critical to avoid the establishment of external credit assessment providers, whose purpose is solely to permit generous ratings, thereby perverting the entire intention of the committee’s work. In a similar vein, Standard & Poor’s is concerned that the committee’s recommendation to permit only one rating, ‘where no eligible institution has given a lower assessment,’ could encourage domestic agencies to give generous assessments, while any internationally established agency would not be requested to rate the debt, and would have insufficient data to ‘rate without request’.

One of the committee’s own documents presents a clear case against this: ‘Unless the lowest rating is used, or certain agencies’ ratings are discounted according to historical experience, the tendency may be for more lenient agencies to determine risk weightings (Bank for International Settlements, 1999). This is one of the reasons that Standard & Poor’s feels strongly that a measurable track record should be a prerequisite for rating agency recognition. Such a track record would then permit a domestic agency’s ratings to be appropriately calibrated to other agencies’ scales. Standard & Poor’s believes that market participants benefit from having more, rather than less, credit risk information available to make lending decisions and that competition among rating agencies can lead to having more information available in markets. However, competition should be fostered on a level playing field among international and domestic rating agencies and should not simply favor the business prospects of new entrants. For markets to derive the greatest value from diverse sources of information, the quality of the information available and impartiality of the information providers are key factors.

2.2.1.2. The differing approaches to rating local currency and foreign currency obligations. Standard & Poor’s generally agrees with the sense of the proposal that foreign currency obligations should be differentiated from local currency obligations, where risks of currency convertibility represent a credit constraint on cross-border foreign currency commitments. There may, however, be considerable diversity in the policies and analytical framework used by external credit assessment providers, and certainly among banks, regarding differentiating local versus foreign currency risks. Moreover, even though the sovereign’s foreign currency rating can generally be used as a ceiling with respect to cross-border foreign currency commitments of corporate and financial sector obligors, the increasing use of sovereign risk mitigation techniques incorpo-
rated into structured securities and the operating policies of large geographically diverse organizations suggest an issue specific rating approach, where available, provides the soundest basis for the risk adjustment process.

2.2.1.3. Differing policies on assigning ratings without the request or cooperation of management. The committee’s proposal does not differentiate between solicited and unsolicited ratings but suggests that a prerequisite of recognition as an external credit assessment provider is the maintenance of an experienced staff and ongoing dialogues with the management of rated companies, implying the cooperation of management in the credit assessment process. Standard & Poor’s is the only external credit assessment provider that currently differentiates the ratings that are assigned without an ongoing commitment from the rated companies’ management to provide both access and timely disclosure of material events. Standard & Poor’s believes that the inclusion in the risk adjustment process of ratings assigned without management’s cooperation is unavoidable given the practice of most rating agencies in not differentiating where or when this is done.

The committee should expect that the inclusion of unsolicited ratings as a basis for risk adjustment may increase the assignment of unsolicited ratings as well as undermine the success of the committee’s proposals. The committee must be wary that permitting any unsolicited ratings, and especially those determined solely through the use of scoring models, will not only undermine the existing market practice of rating agencies, in which the determination of the vast majority of ratings entail significant contact with management and seasoned analytical judgment, but could also cause an adverse reaction among market participants to the committee’s proposals as a whole given the aversion of many market participants to unsolicited ratings. While unsolicited ratings, and even rankings driven by scoring models, can serve to bring incremental transparency to some markets and credits, Standard & Poor’s believes that ongoing cooperative relationships with management provide the soundest basis for rendering credit opinions.

2.2.1.4. Potential differences in how recovery prospects of certain obligations are reflected in ratings. Standard & Poor’s believes that specific issue ratings, because they include incrementally more information, are a more appropriate basis for the risk adjustment process than issuer ratings, but that the process could be extended to encompass issuer ratings as well. The implementation challenges of a new capital adequacy measurement regime will be lessened to the extent regulators adopt an approach which encompasses the most commonly used, and soundest conceptual framework for risk measurement. That framework supplements default probability with the recovery information specific to the contractual exposure and the legal framework in which it is enforced.
It is important to draw a distinction between default risk and ultimate recovery. S&P defines its ratings as a measure of the rated entity’s ‘ability and willingness to repay its obligations in full and on time’. Our debt issue specific ratings usually do not address the likelihood of ultimate recovery in the event of default, the amount of that recovery, or the time it will take to collect any recovery. Ultimate recovery depends enormously on the legal jurisdiction by which loan or bond documentation is governed, the quality of the company’s assets and collateral, and the ranking of a bank’s assets within the liability structure of the defaulting counterpart. To some degree, the existing ratings policies of differentiating senior and subordinated obligations, employing a frequency and severity of default approach in evaluating the cash flow of receivables and loan pools, and incorporating asset protection in loan ratings will contribute to the correlation of ratings prior to default and subsequent recovery prospects. However, Standard & Poor’s believes the appropriate use of its ratings is as a measure of potential default, (or EDF, or expected default frequency) and should be used in conjunction with independent analysis of recovery prospects, or loss given default (LGD).

2.2.1.5. Issue versus issuer ratings. Traditionally, and until 1988, Standard & Poor’s specifically rated issues and not issuers. This permitted us to take into account the seniority of the issue, any covenants contained in the documentation, and any collateral. The majority of our ratings are issue ratings and not issuer ratings. However, Standard & Poor’s subsequently introduced counterparty credit ratings (CCR), and insurer financial strength ratings in effect validating the market’s use of an issuer’s most senior rating as a shorthand for its credit quality. An increasing number of entities that obtain CCRs have no need to access public debt markets, instead using the rating in other credit sensitive transaction markets. CCRs, and issuer ratings in general, do not apply to specific obligations but are current opinions on the issuer’s overall financial capacity and willingness to meet its financial commitments as they come due.

The use of issuer ratings either in conjunction with or as an alternative to issue ratings as a proxy for the quality of the assets in a bank’s book raises several analytical and policy questions that will require guidance during the implementation of a new accord. The most meaningful of these relates to the treatment of unrated subsidiaries of rated parent companies, and differentiating the seniority of, and hence varying probability of, default of different obligations of rated issuers.

2.2.1.6. The use of short-term ratings where no long-term rating is assigned. The proposal cites the potential use of long-term ratings, without mention of short-term ratings – those assigned to instruments maturing in less than one year. The high correlation of Standard & Poor’s short-term and long-term ratings scales allows these to be used within the broad risk categories outlined in the
proposal. Many companies, especially banks, have only short-term ratings from Standard & Poor’s.

2.3. The standard method matrix

Standard & Poor’s realizes that because the risk adjustment process can profoundly affect the flow of funds both through a national economy and across borders, it is not likely to be based solely on analytical factors. Even with this caveat, however, it is not clear why the risk weightings for equivalently rated entities in different industries vary as much as they do. For example, while an ‘A’ rated sovereign credit would get a 20% weighting, an ‘A’ rated bank would be weighted at 50%, and an ‘A’ rated corporate would be 100% weighted. Yet, from an anticipated frequency of default perspective, these credits would be considered equivalent. While considerations of support for sovereigns or banks from the IMF or central banks respectively may affect the weightings, Standard & Poor’s would advise caution in building moral hazard into the proposed capital rules. This is not simply a matter of analytical nicety, since preferential weightings could adversely distort the flow of funds. For example, in cases where it is materially easier for a sovereign to gain access to bank financing than it is for similarly rated banks within its jurisdiction, the sovereign could be motivated to borrow to support those banks. This could have adverse consequences for the sovereign’s own credit, as well as raising a moral hazard issue regarding how the banks would be managed. Each of our concerns in this area will be dealt with separately below.

2.3.1. Sovereign risk and weightings

Standard & Poor’s believes that criticism of individual sovereign rating actions as a rationale for avoiding a more rigorous approach to risk adjusting sovereign exposure is not appropriate. Standard & Poor’s regards the current accord differentiating risk weightings based on OECD membership as analytically untenable given that OECD membership opens significant growth opportunity but is not accompanied by any rigorous credit evaluation process. The current proposal awards substantially lower weights for sovereigns than for similarly rated banks or corporates, already reflecting the presence of a meaningful support infrastructure for sovereigns relative to other credits, and the broader social and political context in which bank lending to sovereigns may sometimes occur.

While the sovereign ratings history for emerging market sovereigns may be relatively brief, the credit performance of the sovereign sector is extensive, and is evidence of significant and variable risk of default (see Standard & Poor’s Sovereign Default Study attached as Exhibit 3). Sovereign ratings provided by the major rating agencies are in fact, highly correlated, especially when one evaluates them in the context of the default probabilities they respectively
imply. For example, of the 70 countries with foreign currency obligations rated by both Standard & Poor’s and Moody’s, the ratings are the same or within one notch in 65 cases, or 93% of the time, and within two notches on four of the remaining five. Contrary to the Basel Committee’s recent criticism of rating agencies in ‘Supervisory Lessons from the Asian Crisis’, this evidences some standardization underlying methodologies and discipline. Sovereign ratings have also evidenced comparable stability with corporate ratings. (See Sovereign Ratings Stability, Standard & Poor’s CreditWeek August 7, 1999, attached as Exhibit 4.) To the extent some volatility in the sovereign sector is driven by confidence related liquidity factors, Standard & Poor’s believes that the creation of standby contingent financing arrangements provided by the official or private sector may avoid or reduce the uncertainty of negotiating conditionality in liquidity support arrangements in times of crisis, thereby contributing to more stable capital flows and more assured sources of sovereign funding.

The proposal to leave the weighting of local currency sovereign debt up to national banking authorities may introduce non-credit considerations into the weighting process. While Standard & Poor’s agrees with the general view that local currency defaults are less likely than foreign currency defaults, we would also underscore the fact that local currency sovereign defaults do occur, as they did it in Russia, and could lead to catastrophic losses since recovery prospects could be minimal.

2.3.2. Treatment of public sector enterprises

The proposal to treat the debt of non-sovereign public sector enterprises (PSEs) the same as a claim on the banks of that country may also result in non-credit-driven outcomes. Standard & Poor’s does not regard all PSEs as identical or even close to the sovereign’s credit risk. Credit differences can be material, and the trend in many countries is to operate more independently of their government shareholders.

2.3.3. The appropriate number of risk weightings

Also noteworthy in the proposed use of ratings is the sharply graduated nature of the weightings. While the weightings for the very strong and the very weak are significantly differentiated, the broad middle range of rated entities is not. Ratings would allow for a more nuanced range of weightings that would better reflect the relevant default probabilities or yield spreads at different rating levels. Moreover, the adoption of sharply graduated weightings could raise the liquidity risk associated with a downgrade, since a relatively small change in a rating could lead to a very large increase in the capital charge associated with lending to the downgraded entity.

The use of external credit ratings, and potentially, the use of bank’s internal risk scores, would enable the bank’s management to measure credit risk and
allocate capital with a much greater degree of accuracy and efficiency than the adjustment process outlined in the proposal. With respect to the use of ratings, Standard & Poor’s believes that weightings aligned with the average cumulative default rates over an intermediate time frame of three to five years effectively capture the average risk differentiation among separate classes of creditworthiness over a time frame appropriate to most bank credit portfolios.

Utilizing these default probabilities and expected severity of loss of 50% yields loss expectations that indicate that the suggested weightings over-weight certain high-quality exposures and, more meaningfully, underweight low-quality exposures. While the existing accord may represent a constraint, the underweighting of very weak credits coupled with the limited weighting differentiation across a broad range of credit, A+ to B− for corporates, will limit the proposal’s effectiveness in capturing the downward credit drift in bank portfolios resulting from capital markets related disintermediation.

This is partly evidenced in Table 1, which indicates the general alignment of ratings and risk weights, but there are considerable differences in what each implies for actual loss exposures.

Given the committee’s intention to maintain a simplified standard approach, the broad categories may be an appropriate implementation constraint. However, the committee may wish to consider a lower risk weighting for A-rated corporate credits, and a higher one for B-rated credits.

2.3.4. Weightings based on maturity

While there is a strong analytical basis for treating short-term exposures as less risky than long-term exposures, there is no analytical reason based on ratings principles that such differentiation should be done only for banks and not for all similarly rated entities (if it is done at all). Given the powerful effects that weightings for maturity can have on the flow of funds, any preferential weightings for short-term exposures should be adopted very cautiously,

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<th>Assumed loss% in default</th>
<th>Implied loss</th>
<th>Corporate proposed risk weight (%)</th>
<th>Implied capital need (%)</th>
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especially given the relatively higher credit and liquidity risk of speculative credits. Ratings behavior confirms lower default for shorter exposure periods. The average one year ratings transition rates, pg. 15 and 33 of the Ratings Performance Study published by Standard & Poor’s in March 1999 (see Exhibit 2), indicate that the maturity benefit is applicable to all levels of credit quality, but is most appropriate for higher-rated credits. Rating stability and hence, credit quality, are increasingly volatile at lower levels, even in the short term. One possible solution – limiting this preferential treatment to higher-rated entities but expanding it across industries to include corporate and sovereigns as well as banks – might mitigate potential adverse consequences.

2.3.5. Assessing banks

The proposal offers two options for the assessment of banks. One method would discount the sovereign rating of the country in which a bank is located by one full grade and apply that to all banks within the country; the second would use ratings on individual banks and give a 50% weighting to unrated banks. The first method, in Standard & Poor’s view, would penalize better-quality banks and could benefit weaker institutions. If a sovereign were rated ‘AA’, for example, then the highest rating any bank could receive would be ‘A’, which would penalize banks with higher ratings, while weaker banks that might be rated ‘BBB’ would also be treated as ‘A’ rated. Use of this method might also imply that the sovereign would bail out its banks, a perception, which not only creates several hazards at the bank management level, but also could be negative for the sovereign’s creditworthiness. The approach is also at odds with the worldwide trend toward less government support for banks and a more credit disciplined interbank market.

The second method at least has the merit of assessing banks individually, even though the 50% weighting for unrated banks would reward banks that would achieve lower ratings on their own. The proposal to treat securities firms the same as banks would make sense only if the second method is chosen and the risk weighting is based on these firms’ own ratings, since there is little reason to suppose that sovereigns would support most securities firms.

The benefit in weighting given to short-term bank claims is analytically sound, since most banks that fail (apart from speculative grade banks in some emerging markets) do so over a sustained period that is sufficient for short-term creditors to exit. This, however, is true for most investment grade-rated companies in most industries. In addition, as already noted, the preferential weighting of short-term over long-term exposures can have powerful effects on the maturity structure of an entity’s funding profile. By creating an incentive to fund short, any preferential weighting of short over long could weaken an entity’s liquidity position, leading to lower overall creditworthiness.
2.3.6. Corporate loans

Corporate credits get the least differentiated treatment under the proposal, with the most highly rated getting a 20% weighting and the lowest rated a 150% weighting. The overweighting of the riskiest credits is an especially important innovation that should greatly improve risk-adjusted capital standards. However, corporates would be disadvantaged relative to similarly rated banks and sovereigns. While Standard & Poor’s understands the caution that is being exercised in adopting preferential weightings, the lack of a more graded approach between the weightings for the least and most risky credits creates a situation where a relatively modest downgrade (for example, from AA– to A+) would lead to a dramatic change in risk weighting (from 20% to 100%).

2.3.7. Securitized assets

The treatment of securitized assets is the most differentiated, with weightings of 20% for the highest rated issuances to a 100% capital charge for those issues rated ‘B+’ or below. This sharp differentiation is appropriate in principle, given the greater potential for loss on a combined frequency plus loss basis in the lower-rated issues. The directive to national banking regulators to charge some capital against securitized assets that use certain structures is appropriate, but the caution here is that many structures are in use and the extent to which risk is transferred can vary widely. The proposal would likely reduce banks’ potential to engage in regulatory risk arbitrage, where the appearance of risk transfer through securitization occurs rather than real risk transfer. It could, however, stimulate the creation of newer structures that would more effectively remove risk from banks’ balance sheets. In addition, the preferential weightings for most tranches of securitized structures, notwithstanding the higher-capital charge against the higher-risk tranches, could accelerate the restructuring of bank loan portfolios.

The differential weighting treatment between securitized assets and bank or corporate assets does, however, create opportunities for regulatory arbitrage. Under the current proposals, an asset-backed vehicle could hold 100% A-rated corporate loans and, with very little or no credit enhancement, see the risk weighting for these assets reduced from 100% to 50% automatically, where no change in the risk profile of the assets had occurred.

2.3.8. Off-balance sheet risk

As part of the committee’s stated goal of addressing regulatory arbitrage, the implementation of a capital charge for off-balance sheet commitments is appropriate, as is the lower-risk weighting for these exposures.

2.3.9. Separate capital charges

Aside from risk adjustment, the proposal makes important points about the regulatory approach to capital. It envisions a separate capital charge for both
interest rate and operational risks, charges not explicitly mandated in current legislation. Both areas are important, and it is a major positive development that the proposal addresses them. While interest rate risk has recently receded as a major issue for most banking systems outside of emerging markets, it is still important for institutions in some systems, especially for banks that originate and hold longer-term fixed rate assets. However, an outlier approach may not be sufficiently comprehensive. For example, some banks have many of their assets in high-quality government bonds that generate little or no capital charges but carry the associated interest rate risk of these investments. While they may not be outliers, they should still have capital allocated against this interest rate risk, since there is no capital allocated for credit risk. Operating risk, while difficult to quantify, becomes increasingly important for capital consideration as banks emerge that have little lending risk but potential exposure to problems in their extensive processing businesses.

2.3.10. Emphasis on consolidated analysis

The proposal's emphasis on consolidated analysis for banks, including holding companies and non-bank subsidiaries, is an important advance over current practice in some systems. Unconsolidated affiliates or subsidiaries pose risks to the banking parent or lead bank within a banking family, since creditors in many systems look to the source of strength within the family as their last resource. Accordingly, proper measurement of capital adequacy can be done only on the broadest possible consolidated basis. In cases (for example, insurance subsidiaries), where the proposed approach would deduct the capital dedicated to the subsidiaries from total consolidated capital, the deduction should be applied in the same manner in all systems and be reflected in Tier 1 capital, not just total capital.

2.4. Proactive regulatory review

In addition to the risk-adjusted approach to capital adequacy, the proposal calls for proactive regulatory review of banks' capital adequacy on an ongoing basis, with the clear understanding that regulatory authorities can set standards above the minimums when circumstances dictate. In Standard & Poor's approach to bank ratings, an assessment of the regulatory framework and its effectiveness is an important consideration that materially affects ratings outcomes for individual banks within a given banking system.

Accordingly, any measures that lead to an improved, more effective regulatory environment can have positive rating consequences, especially for banks in less developed markets with regulatory regimes that Standard & Poor's has judged less effective. More proactive regulatory intervention in situations where capital is deteriorating might also encourage regulators to stop payment on preferred or other junior instruments that have been issued as risk capital.
Regulators have been reluctant to take such action in the past, but Standard & Poor’s has anticipated this development in its rating approach to these risk capital instruments.

2.5. Improved disclosure

Standard & Poor’s strongly supports the committee’s encouragement of improved disclosure, especially in the area of asset quality, in the interest of stimulating greater market discipline. Counterparties to banks are entitled to have the best information possible, and public reporting on asset quality in many banking systems is remarkably poor. Consistency of asset classification regimes is equally important, since cross-system comparisons are hard to do without it.

2.6. Other issues

The proposal raises a number of subsidiary issues, such as how credit may be given to credit derivatives, transactions and collateral. On the first issue, Standard & Poor’s would note that while credit derivative transactions could be effective mechanisms for risk transfer, it is hard to quantify the amount of any capital credit, which would depend on the extent to which credit risk is actually transferred. As with securitization, the variety of transactions might require a variety of responses. It might alternatively be better to give credit for the use of credit derivatives in the overall assessment of a bank’s risk management rather than give explicit capital credit. As for collateral credit, Standard & Poor’s would cautiously support the committee’s proposal to broaden the kinds of collateral that would be given credit in the risk-weighting process, provided the collateral truly be of high quality and have a ready market, and that the bank be able to track the collateral in its internal information systems. Standard & Poor’s would not support any proposal to give preferential credit for secured real estate loans, other than for single-family mortgages, or for loans secured by equities, commodities, or other volatile forms of collateral.

3. Recognition of external credit assessment providers

In addition to the many technical issues outlined above, Standard & Poor’s requests that the committee, should it adopt the use of external credit assessments, provide an open, cooperative process, in which the ratings industry can actively and meaningfully participate. The issues of rating agency authorization and regulation, as well as the maintenance of a healthy and robust competitive environment for external credit assessment providers, are fundamental
to the rating agencies’ ability to continue to serve the development of capital and credit markets globally.

Standard & Poor’s believes rating agencies best serve capital markets when they have a wide-spread reputation for being credible and objective and, most importantly, when they operate independently. As discussed above, Standard & Poor’s believes credit ratings are a valid consideration for the risk adjustment process. However, due primarily to the negative impact on rating agencies’ independence and on the quality of reputable agencies’ ratings as a whole that can result, we have historically neither advocated nor encouraged the use of ratings in regulation. Our concerns in this area include the following:

First, an increased regulatory use of ratings creates the potential for increased regulatory efforts by various national regulators to influence or control ratings agencies, thereby jeopardizing the industry’s independence and credibility, both cornerstones of our integrity in the market. Such a trend, evidenced by the imposition of criteria, methodological, or operational requirements, at least as they would pertain to content regulation, will undermine the successful role ratings agencies play in the development of capital and credit markets. The regulatory incentives for intervention may rise as a consequence of incorporating external credit assessments into a standard risk adjustment process for banks to the extent that banking industry regulation has been a vehicle for implementation of broad government economic or social goals.

Ratings serve markets best, and can best assist in the risk adjustment process for banks, if used properly by the market regulators. Credit ratings are, simply stated, opinions on the likely risk of default by an issuer on its obligations. Rating opinions represent an analytical judgement based on a wide range of factors, and subjective analysis.

Second, while it is not the intent of the proposal, regulators must take care to prevent the use of ratings as an improper substitute for the credit risk analytical or management disciplines fundamental to sound banking. Ratings are intended to supplement the credit research conducted by market participants, not supplant it. Buttressing the potential use of external risk assessments, with improved disclosure and enhanced supervisory capability in reviewing risk management practices will help mitigate this risk.

Third, the use of ratings either external or internal as a basis for risk adjustment may create a preference among banks for the highest rating available. This could have adverse market implications. To some extent, this competitive market dynamic already exists in the ratings industry and is healthy to a degree, but is likely to intensify as a consequence of utilizing ratings in the risk adjustment process, especially if either bank management or the national authority that regulates banks attempt to realize competitive capital advantages by consistently selecting credit assessment providers that generally award higher ratings. A Federal Reserve study conducted in 1996 concluded that smaller ratings agencies had a consistent, measurable bias toward higher
ratings when compared to either Standard & Poor’s or Moody’s (Cantor and Packer, 1996). This was attributed to ‘less rigorous standards’ adopted by the smaller agencies. Regulators must be wary of the potentially negative ratings industry and market consequences of promulgating a regulatory framework that does not adequately differentiate among the quality of credit assessment providers, thus turning ratings into a commodity.

Fourth, Standard & Poor’s concurs that, should external credit assessments be used to establish risk weightings, the increased reliance on rating agencies would require that recognition criteria be set at an appropriately high standard as outlined in the proposal. Standard & Poor’s supports the need for high standards and professionalism, but believes the market itself, through its discriminating choice of ratings and rating agencies, remains the best and most rigorous judge of the committee’s proposed minimum criteria: quality, objectivity, independence, transparency, credibility, access, resources and recognition. Market acceptance and judgment of rating agencies implicitly take these factors into account, including whether agencies’ criteria, methodologies and ratings have been tested over a sufficient period of time and are publicly available. We have noted the European Commission’s recent consultation document and discussion of recognition criteria. We will be addressing this issue with regulators in due course.

Standard & Poor’s values and encourages differing opinions on credit risk and as much information as possible to explain the opinions. As ratings are opinions, and not statements of fact, they are not right or wrong in an absolute sense. Controversy surrounding rating opinions is healthy and encourages dialogue. It also speaks to the independence of the process. For this reason, Standard & Poor’s welcomes the availability of more, rather than fewer, rating opinions for purposes of the committee’s proposal. However, we are concerned about the quality of permitted ratings where a rating agency’s reputation, credibility and independence have not been established or tested. We have also observed with great concern that without a track record and established criteria and methodologies, regulators may seek to regulate the rating process. For example, regulators may impose criteria requirements or mandate how rating committees should be staffed and conducted.

Regulators may also require ratings to be disseminated in a certain manner and timeframe and reserve the right to inspect a rating agency’s files and attend internal meetings. Regulators may also impose vague and overbroad restrictions to prevent conflicts of interest. Regulations of this type can impair the core principle of independence by affecting the content of the rating process and rating agencies’ daily operations.

These regulations go beyond recognition criteria that establish a fair and straight-forward process for recognizing rating agencies, whose ratings are proposed to satisfy a regulatory requirement.
‘Content’ regulation can lead to regulators substituting their own opinions for a rating agency’s and causing market participants to regard regulators as endorsing the ratings and rating providers. Standard & Poor’s believes that substantive regulation does not ensure the quality of ratings or rating agencies, the primary goals of regulatory intervention.

To the extent recognition criteria are adopted that exclude or limit the influence of broad market recognition and acceptance, Standard & Poor’s believes that certain of the criterion must be strengthened, particularly the proposal that assessment methodology need only be back-tested for one year. Such a lenient criteria is inadequate to judge the performance, and hence, objectivity, of any credit risk assessment methodology – either that of external providers or the banks’ internal ratings.

Standard & Poor’s acknowledges the operational complexities inherent in charging each national supervisory authority with responsibility for recognition of external credit assessment providers. Decentralization, while appropriately acknowledging the need for local authority, may potentially create a burdensomely diverse set of recognition and reporting requirements for global rating agencies. Diverse compliance and interpretation issues would create time and resource constraints for both ratings agencies and the authorities responsible for compliance. Consequently, Standard & Poor’s would welcome and looks forward to cooperating with any effort to develop common recognition criteria and a clearinghouse mechanism for the sharing of information should the committee incorporate the usage of external credit assessments in any meaningful way. The recently published proposal by the European Commission does suggest this for the European Community and any further efforts on a regional or global basis would be welcome. It remains important to Standard & Poor’s that the resolution of this issue not impair our objectivity and independence, the integrity of the rating process, and the quality of our ratings.

One alternative may be to strengthen the role of the Basel Committee in this regard, and have this institution, under the guidance of a representative number of local regulatory authorities, establish and maintain a common framework.

A fifth and more market oriented concern is the potential for the use of external assessments to introduce an incremental element of systemic risk. It remains unclear precisely how greater ratings usage in the banks loan book will affect lending behavior and related capital flow and liquidity issues. In broad terms, however, Standard & Poor’s ratings are based on a prospective outlook over an intermediate term and, as such, ratings tend to be less volatile indicators of creditworthiness than market prices of financial obligations, which may reflect market sentiment and liquidity factors. Consequently, ratings provide ballast to the market and are a stabilizing influence, evidenced principally by the convergence of yield spreads and ratings in the vast majority of cases.
4. Conclusion

We appreciate the opportunity to comment on the proposal and look forward to providing the committee with any additional information or background on either the issues raised in our response, or that might be helpful to the committee in its research.

References

