A critical review of the new capital adequacy framework paper issued by the Basle Committee on Banking Supervision and its implications for the rating agency industry

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Abstract

This paper will concentrate on two main areas. First, on the way in which the Committee intends to allocate capital by assessing risk on the basis of both external and internal ratings and, second, on how it intends to use recognised independent rating agencies. It also includes a comment on bank disclosure. The paper is written from the perspective of Fitch IBCA (FI), the world's third largest international rating agency. As a result, other institutions, possibly with a different perspective, may not agree with its contents. © 2001 Elsevier Science B.V. All rights reserved.

JEL classification: G11; G20; G21; G31

Keywords: External ratings; Internal ratings; Capital allocations; Bank disclosure

1. Risk assessment on the basis of external ratings

1.1. General remarks

Fitch IBCA's (FI) principal observation is that the Committee is proposing to use ratings at variance with the way rating agencies design them to be used,
and this could lead to the wrong incentives being given to the market. FI endeavours to make its rating categories consistent. Therefore, when we assign a rating of, for example, ‘A’, we are doing this on the basis that the default characteristics of any bond or other obligation so rated, issued in any jurisdiction whether by a sovereign, bank or corporate entity, will be comparable. However, the Committee’s proposal is, in effect, affirming that a sovereign rated between ‘AA–’ and ‘AAA’ is a better credit risk than either a bank or a corporate with the same rating. And, it is implicitly arguing that a sovereign rated between ‘A+’ and ‘A–’ is a better credit risk than a bank with the same rating, which is itself a better credit risk than a corporate with an identical rating. We know of no evidence showing this to be the case. Indeed, if there were, we would change our ratings.

FI assumes that the purpose of the new capital adequacy Accord is to bring supervisory capital requirements more into line with the best assessments of underlying risk. This in turn should help reduce regulatory arbitrage. In addition, the Committee is assuming, we hope correctly, that bringing to their aid outside entities, such as rating agencies and export credit agencies, will provide national supervisors with the best independent assessments of these risks. But, the system the Committee proposes will result in a mix of the rating agencies’ points of view, with superimposed on it the views of the regulators. FI believes the Committee would create a far better credit culture in the banking market if it were to allocate capital by employing ratings on a consistent basis. Such an approach would also avoid the political issues that would inevitably dog the Committee if it were to add its own views to those of the agencies. FI appreciates the inevitable political difficulties in effecting a change as significant as the one the Committee is proposing, and we assume that the greatest difficulty is with sovereigns.

That all the rating agencies, along with the vast majority of economic commentators, failed to foresee the Asian crisis quickly enough is not an argument for assigning sovereigns preferential status, but rather for requiring more research. A significant proportion of FI’s research effort is aimed at ensuring our rating categories are consistent across economic sectors and countries. For example, we are currently working on bank default studies in both the US and Europe, and reports on municipal defaults in the US, and corporate defaults in Europe. Once we have this data, it may well be that we shall adjust some of our outstanding ratings, but the aim will always be to keep our rating categories consistent.

As a compromise, if political issues were indeed to become dominant, FI would suggest that banks and corporates should be allocated capital on a consistent basis of weightings, and sovereigns given some sort of advantage. This could perhaps be a one-notch benefit in their favour, although we must reiterate that there is no evidence to show that sovereigns of a given rating category are actually better credit risks than private sector companies with a similar rating.
1.2. Bank ratings

The Committee has put forward two options:

- Firstly, that all banks in a country would have the same rating, and this would be dependent on the country’s sovereign rating; and
- Secondly, adopting the actual ratings assigned by recognised rating agencies.

The specific risk weightings under each option are detailed in Table 1. FI advocates strongly that the Committee should use Option 2; Option 1 would have no credit logic whatsoever, and could result in severe distortions, especially in the case of banks in developed countries. (We note that the European Commission has since stated that Option 1 would be illegal within the European Union because it would necessitate discrimination among member countries.) In developing countries, for which the sovereign rating is often quite low and acts as a ceiling for all ratings, the distortions would be less marked. Effectively to postulate that the riskiest bank in any particular country has the same credit standing as the most prudent would in no way help market discipline, but would fly in the face both of reality and of the current trend in public policy, which is to accept that banks are, for the most part, no longer ‘special’ and hence, are unlikely to receive external support if they run into trouble.

Both options also have difficulty in treating unrated entities. Specifically, they look upon unrated entities more favourably than rated entities at the lower end of the ratings scale. (This is also true for corporates and sovereigns.) The most stark example of this is Option 2, which weights banks rated below ‘B−’ three times more heavily than for unrated entities. Clearly, it is unfair to penalise rated entities, and such treatment may hold back the development of credit ratings, especially in emerging markets. However, there is no easy solution to the treatment of unrated entities, although perhaps a more equitable approach would be to rate them on a par with entities rated below ‘B−’.

### Table 1

<table>
<thead>
<tr>
<th>Claim</th>
<th>Rating (%)</th>
<th>AAA to</th>
<th>A+ to</th>
<th>BBB+ to</th>
<th>BB+ to</th>
<th>Below</th>
<th>Unrated</th>
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<tr>
<td>Option 1</td>
<td>20</td>
<td>50</td>
<td>100</td>
<td>100</td>
<td>150</td>
<td>100</td>
<td></td>
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<tr>
<td>Option 2a</td>
<td>20</td>
<td>50</td>
<td>50</td>
<td>100</td>
<td>150</td>
<td>50</td>
<td></td>
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<tr>
<td>Corporates</td>
<td>20</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>150</td>
<td>100</td>
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</tbody>
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*a Under Option 2, short-term claims (e.g. less than 6 months) on banks would receive a weighting one category more favourable than usual.
1.3. Corporate ratings

Although we understand the concerns of some authorities that their banking systems will be discriminated against because of the lack of ratings in their country, we believe that the Committee is possibly in danger of ‘levelling down’ rather than of ‘levelling up’. As we understand it, the reason the Committee has proposed that only entities rated between ‘AAA’ and ‘AA−’ should have a reduced capital charge is that a wider and more diversified scale of weightings would be unfair to corporates in a country where ratings are not the norm. FI is, of course, biased, but nevertheless, we find it hard to believe that the difficulties and costs of getting a rating are such as to require the proposed discrimination against ‘A’ rated corporates. The typical ‘A’ rated company has sales of around $4 billion, equity of over $1.5 billion and earnings in the range of $150 million to $250 million. The cost of obtaining a rating varies, but in our case would be in the region of $30,000–$50,000. In addition, FI provides initial, indicative ratings for no charge, so that a corporate does not have to go through the whole process only to be told at the end that its rating is too low for it to gain advantage from the Basle criteria. Companies of this size have ample resources to pay for the rating process if they so wish. If the Committee sets the ratings at the level suggested, it will constantly be petitioned by companies which have been rated, urging that they should gain the same benefit from their ratings as that achieved by banks and sovereigns. They will argue, with some justification, that the system is unfair.

A second potential problem with the corporate ratings system is that it could cause undue volatility. The reality is that the change in default rates as a company moves from the ‘AA’ range to the ‘A’ range is very small. However, under the proposal, if a company dropped from ‘AA−’, this would require a bank to put up five times as much capital. Such a sharp non-market related difference would almost certainly lead to significant regulatory arbitrage and possibly greater volatility. (Similar, but less compelling, arguments could be put forward for banks which are also subject to significant but less dramatic changes in risk weightings – see Table 1.) One possible solution would be to improve the gradation of the risk weighting, perhaps in conjunction with an expansion to the rating categories themselves. However, whilst such an approach may help address the issue of ‘credit cliffs’, it could undermine one of the amendment’s greatest strengths, i.e. its relative simplicity.

1.4. Multilateral development banks

We make the same comment with regard to multilateral banks as we have in the rest of this submission. Currently, all the multilaterals are in the ‘AAA’–‘AA−’ range. However, there are a number of banks that might be described as ‘development banks’ which regularly describe themselves as multilaterals and
whose ratings are considerably below this range. FI believes it would be better to drop all reference to multilateral banks, which implies they are a special case, other than saying they would be weighted on the same basis as other banks. This, of course, assumes that the Committee has chosen Option 2 rather than Option 1 with regard to bank weighting.

1.5. Loans secured by property

We concur with the Committee’s view that commercial property lending should have a 100% weighting. Most systemic banking problems have involved very large losses on commercial real estate, and to give such lending a lower weighting than other forms of lending would be wholly at variance with the stated aim of the paper, which is to bring regulatory and market risk assessments closer together. The Committee should also take into account that the rating of loans is gaining acceptance in many markets. At the moment, this practice is more common in the United States than in Europe, but it seems to us likely that it will come to form the basis for a major rating activity in Europe. FI assumes that separately rated loans collateralized by charges on commercial property would feature in the ‘Corporates’ line of Table 1.

2. Risk assessment on the basis of internal ratings

It appears to FI highly desirable that banks should develop internal rating systems that are sufficiently robust to be acceptable to the regulators. There are a number of areas where external ratings will never be important. However, it makes sense to us that a bank should be entitled to use its internal model or models, in those cases where it can produce convincing evidence that a certain sector of its loan book has characteristics which may be defined in terms of an overall rating. Given the current development of default information, it appears to us likely that such internal models will be introduced on a piecemeal basis. For example, a bank might have a very good model of credit card lending but a very poor small business lending model. The Committee is doubtless aware that many banks believe the new Basle Accord is going to be a godsend to them, because they hope they will be entitled to use their internal ratings systems from day one. It is our experience that very few banks have internal rating systems sufficiently sophisticated to allow them to claim they are an alternative to either external ratings or a full risk weighting.

3. Use of rating agencies

The rating agency business already constitutes an oligopoly, and we are confident that the Committee and other regulators will want to make sure that,
to the extent possible, there is healthy competition within the sector. We also start from the position of assuming FI is going to be recognised and we are not, therefore, making any special pleadings. FI agrees with the concept that rating agencies should be recognised by their own host country regulators. Although we understand any concern the Committee may have that new rating agencies will not possess the necessary professional competence, we consider the risk of a rogue agency causing damage to be limited as the market will surely decide whether rating agencies are credible or not.

FI also suggests that the Committee give considerable thought to precisely which rating agencies’ ratings a bank should use. The Committee has already taken the stance that it will not allow banks to “cherry pick”. Nevertheless, if the Committee wants to allow new entrants into the sector, it will have to take some note of their ratings. Our suggestion is that a bank should take note of all the ratings it has received and then use some subset of these. FI disagrees with the argument that only the lowest rating should be considered. Although at first sight this might appear to be a conservative measure, in fact it would be seen by the market as giving rating agencies far too much power. Also, from an analytical and intellectual perspective, a rating that is too low is as equally incorrect as one that is too high.

In addition, there will be a number of technical questions which will arise if the Committee decides to go ahead with the use of external ratings. However, these are largely beyond the scope of this paper and, therefore, are not addressed.

4. Disclosure

There are a number of other important issues that the consultative paper brings up, although they are not necessarily closely related to ratings. The Committee will doubtless receive many comments on these, but FI wishes to single out part of the third pillar of the paper, which relates to disclosure. Indeed, we think it quite possible that the requirement for better disclosure will have the most profound impact of all the changes suggested in the paper. Despite the improvements that have occurred in bank disclosure over recent years, it is still the case that, for many banking systems, both in developed and developing countries, the standard of disclosure remains extraordinarily poor. It is our experience that poor disclosure not only impinges on market discipline but also prevents management making the right decisions. We have frequently found that banks which have poor disclosure have inadequate internal management information systems. This in turn leads to detrimental decisions being taken at all levels for the bank. We therefore particularly welcome and support the Committee’s moves to reinforce this area of market discipline.
5. Other issues

In addition, FI welcomes the Committee’s recognition that supervisors should have the ability to require banks to hold capital in excess of minimum regulatory requirements. Whilst this is common in some countries, it will require changes to the law in others. Nevertheless, by allowing supervisors to improve the correlation between the risk profile of a bank and its regulatory capital requirement, the financial soundness of banking systems and the effective allocation of capital should be improved. FI also approves of the Committee’s intention to widen its definition of recognised collateral and guarantees from the current set, which includes cash, OECD government and public sector securities and guarantees, and OECD bank guarantees. Such a move should further encourage the use of collateral and guarantees, and therefore, reduce a bank’s exposure to credit risk. Finally, although the Committee recognises that the risk of an exposure differs according to maturity, it does not take it into account (with the exception of some forms of bank exposure). However, FI appreciates the complexities and difficulties in implementing a system of greater risk delineation based on maturity. Indeed, ratings agencies are equally culpable, utilising only two basic maturity classes, short-term (under 12 months) and long-term (over 12 months). Nevertheless further work on this issue would be welcome.

6. Conclusion

Despite the criticisms detailed above, FI believes that the proposed amendment to the capital Accord will substantially improve the original 1988 Accord, about which many industry participants have been disparaging almost since its conception because of its simplicity. Specifically, the amended Accord will improve banks’ knowledge of their exposure to credit risk and, therefore, will help to strengthen risk management procedures and systems, including more efficient allocation of capital, by strengthening the relationship between economic and regulatory capital. As such, it will be of overall benefit to the banking industry.

6.1. Implications for the rating agency industry

Although the proposed modification to the 1998 Accord may significantly increase the role of ratings and rating agencies, it is not the first time ratings have been utilised by regulators. For example, in the US, they have been used extensively by regulators for many years, whilst the 1995 Capital Adequacy Directive, and subsequent 1997 Amendment to the 1988 Accord, afforded ratings a global, albeit modest, role in the calculation of regulatory capital
needs for market risk. Nevertheless, the current proposed revisions to the Accord might substantially increase the role of ratings and further institutionalise their regulatory role, thereby, increasing both their importance and rating agencies’. However, FI does not see this resulting in greater responsibility since, given its position in the industry, it is already accountable to its investor and issuer client base.

6.1.1. Will the amended Accord be a bonanza for the rating agencies?

Assuming the Committee eschews the option of rating all the banks in a country the same and instead adopts the actual ratings assigned by the recognised rating agencies, many commentators believe that the amendments to the Accord will be a boon to the ratings industry. FI, however, does not subscribe to this view. Although the proposed changes will be beneficial to the industry in general terms, FI already has comprehensive ratings coverage of the banking industry, as well as sovereigns. In business terms, therefore, the proposals will only have a significant impact on the corporate market, which has the lowest instance of ratings penetration by all the major rating agencies. FI would argue that greater significance should be attached to the continuing impact of financial distintermediation on banking and global debt markets. For example, if banking in Germany was restructured, allowing its debt markets to play a greater role in the financing of the country’s industry, this would have a major impact on the use of debt ratings and FI ratings coverage.

Because of the modest impact of the Committee’s proposals, FI does not believe their implementation will encourage new entrants into the industry. This reflects the fact that barriers to entry into the industry are extremely high. Therefore, the probability of successfully establishing a new global rating agency is extremely remote. It is possible, however, that niche rating agencies (either by sector or geographic location) will be established. However, such agencies would find operating conditions extremely difficult, and those that were ultimately successful, probably acquired by one of the ‘Big three’. Indeed, the Committee’s proposals will benefit those agencies with the greatest coverage. As such, it will further oligopolise the industry, increasing the gap between the ‘Big three’ and the rest of the market.

6.1.2. Will the amended Accord result in the industry becoming regulated?

The issue of who rates the rating agencies has been debated since the industry was first established. FI believes that the proposed changes to the capital Accord will further fuel this debate given the perception of increased power for the industry. However, it is unlikely that the Accord will add to the formal regulatory burden of rating agencies. FI (and other agencies) is already regulated at the point of entry, i.e. in order to establish a presence in a local market, virtually every country operates a formal approval process from the local securities authorities. Once this has been received, whilst the ongoing burden of
regulation is negligible, agencies are still responsible to the local authorities and may be expelled from a market if found to be acting in an inappropriate or irresponsible manner. In addition, any increased formal regulation would have to overcome formidable practical obstacles, not least how can opinions be regulated?

Whilst formal regulation of the industry is minimal, informal regulation is ever present. Specifically, market forces, confidence and judgement are by far the most significant regulatory influences affecting the ratings industry. No rating agency can afford to lose its market credibility since, ultimately, it is merely a formal mechanism for expressing credit opinions. Without its reputation, therefore, those opinions become worthless and its franchise eroded. Consequently, a ratings agency has to behave responsibly and clearly articulate its policies and decisions, otherwise the market will judge it harshly and quickly marginalise its activities.

6.1.3. Implications of deciding between different ratings?

One practical issue that remains to be resolved is how the Committee proposes to choose between the various ratings assigned to the same counterparty by the different rating agencies. For an example, XYZ Bank could be rated ‘A–’, ‘A’ or ‘A+’ by FI, S&P and Moodys, respectively. In this case, which ratings would apply to the bank for the purposes of the Accord? Different approaches would have different implications for the industry. Taking a compromise approach whereby the average rating was calculated would strengthen the hands of the industry’s existing large players, since they have the greatest coverage. Alternatively, selecting the average of the highest or lowest two ratings could encourage agencies to rate aggressively or conservatively, especially those trying to build market share. In addition, issuers could be tempted to engage in ‘ratings surfing’, whereby they solicit ratings from a variety of agencies only to use or publish those ratings that are most favourable. Clearly this issue needs careful consideration and could have significant implications for the industry’s larger players.

6.1.4. The use of credit models

Many commentators have stated that if banks ultimately move to a system of credit models to assign ratings to their counterparties, it could have negative implications for the agencies since it would diminish the role of their ratings. Whilst this is partly true, FI sees the use of credit models as an overall positive influence on the industry. Such models improve banks’ knowledge of their risk profile and, therefore, strengthen risk management systems. In addition, by assigning ratings, which should be comparable across institutions, banks will be able to build up a database of default rates and recovery statistics across industries. Such information is useful to everyone, especially since it improves risk pricing and makes it easier for financial institutions to securitise assets.
Obviously, the latter factor would be of benefit to the rating agencies, which have profited significantly from the growth of securitised debt markets throughout the world over the last 10–15 years. (The asset securitisation market and, therefore, rating agencies will also benefit from the Committee’s proposal to risk weight securitisation tranches according to credit rating given that many issues currently receive a 100% weighting.)

However, credit models are only likely to be of substantial benefit to large, sophisticated banks, given the costs involved in building such systems. Also, regulators will find it difficult to compare models across institutions, including those in the same country, never mind cross-border. Model consistency, therefore, will be a major issue, although over time, the methodology employed will inevitably converge, as it has done over the last 10 years for VAR models used to measure banks’ exposure to market risk.