Client Update
Basel Committee Proposes Constraints on Use of Internal Model Approaches

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On March 24, 2016, the Basel Committee on Banking Supervision (the "Basel Committee") published a consultation on "Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches" (the "Consultation"). The proposed changes reflect ongoing review by the Basel Committee of its credit risk capital framework aimed at: (i) reducing the complexity of the Basel regulatory capital framework and improving comparability across institutions and jurisdictions; and (ii) addressing what the Basel Committee perceives as excessive variability in the regulatory capital requirements for credit risk. Comments on the Consultation are due by June 24, 2016.

Showing the Basel Committee's desire to complete this standardization process, and its rulemakings more generally, the Consultation also notes that the Basel Committee has committed to finalizing the rule by the end of 2016. Of course, individual jurisdictions will need to implement the rule thereafter for it to be effective. Notably, the Consultation does not replace the anticipated Basel consultation on standardized capital floors for banks; rather, the Basel Committee states that it is still working on the "design and calibration" of the capital floor proposal and believes it will "complement the proposed constraints" described in the Consultation.

The Consultation formulates policy suggestions based on a multi-year analysis performed by the Basel Committee's Regulatory Consistency Assessment Programme on banking book risk-weighted assets variation.[1] The analysis concludes that a significant source of overall risk-weighted asset variation arose

[1] This analysis is memorialized in two reports published by the Basel Committee on July 5, 2013 (https://www.bis.org/publ/bcbs256.pdf) and April 1, 2016 (https://www.bis.org/bcbs/publ/d363.pdf).

from modeling choices made by banks in implementing internal models, rather than from differences in underlying risk.

The Consultation contains three sets of proposals centered around introducing constraints on the use of the internal ratings based ("IRB") approaches to calculating credit risk-weighted assets, including constraints on both the foundation IRB (the "F-IRB") approach and the Advanced IRB (the "A-IRB") approach.[2]

We summarize key aspects of each of the proposals in the sections below.

Roadmap to the Consultation

Section I summarizes the Basel Committee's proposals to remove the option to use the IRB approaches for certain exposures for which the Basel Committee has determined that model parameters could not reliably be estimated for regulatory capital purposes.

Section II summarizes the Basel Committee's proposals to adopt exposure-level, model-parameter floors to ensure what the Basel Committee considers to be a minimum level of conservatism.

Section III summarizes the Basel Committee's proposals to narrow the range of permissible parameter estimation practices to reduce what the Basel Committee sees as an unacceptably high level of variability in risk-weighted assets.

Section IV discusses the interaction between the Consultation and other upcoming Basel initiatives, in particular, the upcoming capital floor consultation.

Although the Basel Committee has stated that the purpose of the Consultation is not to "significantly increase overall capital requirements," the Consultation's proposals for exposure-level floors on model parameters are expected to directly impact large portions of the banking book for at least some banks, particularly

[2] Broadly speaking, the IRB approaches allow banks to rely on their own internal estimates of risk components in determining the capital requirement for a given exposure. In contrast, the standardized methodology (the "Standardized Approach") requires banks to rely on supervisory inputs to calculate their risk-weighted assets for credit risk. The key difference between the F-IRB approach and the A-IRB approach is that the F-IRB approach only allows banks to provide estimates of probability of default (relying on supervisory estimates for other relevant risk components), while the A-IRB approach requires banks to calculate a wider range of inputs.

non-U.S. banks.[3] By contrast, U.S. banking organizations are less likely to be affected by the proposed changes because of the Collins Amendment, which requires banks that calculate their capital ratios under the U.S. equivalent of the IRB approaches (i.e., "advanced approaches") to perform separate capital calculations under the Standardized Approach. The binding constraint is the approach that requires the highest capital requirement. This U.S. specific approach eliminates for U.S. banks any advantage that an IRB approach otherwise would provide.

More generally, together with other recent Basel Committee consultations, including the Basel Committee's March 4, 2016 proposal to eliminate internal models for operational risk[4] and its January 14, 2016 final revised market risk capital framework, which significantly enhanced the qualitative requirements for banks to use internal models to model market risk in the trading book,[5] the Consultation reflects a desire to migrate away from internal models and does little to ease industry fears about a migration to "Basel IV."

I. SCOPE OF USE OF INTERNAL MODELS

The Basel Committee has concluded that, with respect to the exposures described below (each of which is currently modelable under an IRB approach), one or more of the following factors is present: (i) the quantity and quality of relevant data available for the estimation of model parameters are insufficient (*e.g.*, with low-default exposures, where comparatively little default data exists); (ii) individual banks do not have access to material amounts of information or specific knowledge beyond that provided by rating agencies or other publicly available sources that would enhance the reliability of internal estimates; and/or (iii) modeling techniques are insufficiently robust or insufficiently capable of validation and have shown disparate results. As a result, the Basel Committee is proposing to:

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[3] *See* Donna Borak and Margot Patrick, Global Finance: Plan Aims To Curb Bank Risk Models WALL ST. J (Mar. 25, 2016) (reporting that financial institutions in Japan, Switzerland, Singapore and Scandinavia potentially must bear most of the additional burdens of these limits, which may not be negligible).

[4] *See* Basel Committee, Standardised Measurement Approach for operational risk (Mar. 4, 2016), *available at* http://www.bis.org/bcbs/publ/d355.pdf.

[5] *See* Basel Committee, Minimum capital requirements for market risk (Jan. 14, 2016), *available at* http://www.bis.org/bcbs/publ/d352.pdf.

- **Permit only the Standardized Approach for exposures to banks and other financial institutions, large corporates and equities.**

Scope of "Financial Institutions. Notably, consistent with the existing Basel framework, the Consultation defines exposures to "financial institutions" to include exposures to securities firms (broker-dealers) subject to comparable supervision to banks (but not other securities firms), insurance companies, claims on domestic public sector entities that are treated like banks under the current Standardized Approach and multilateral development banks that do not meet the criteria for a zero percent risk weight under the Standardized Approach. The removal of the IRB approaches for these exposures would represent a further burden (in addition to the Single Counterparty Credit Limits and other burdens) on the financial counterparty businesses of many banking institutions.

Large Corporates. The Consultation defines large corporates as corporates belonging to consolidated groups with total assets exceeding €50 billion. This category could include large securities firms (broker-dealers) that do not meet the definition of "financial institution."

Equities. The Consultation notes that the proposed revisions to the IRB approaches (which focus on credit risk) only are relevant to equities held in the banking book. The Consultation would not impact the treatment of the equities held in the trading book (which generally represents the vast majority of equity holdings).

- **Remove the availability of the A-IRB approach (only) for exposures to corporates that are a part of consolidated groups that have annual revenues greater than €200 million.**

F-IRB Approach Remains Available. Exposures to corporates belonging to consolidated groups with total assets less than or equal to €50 billion and annual revenues greater than €200 million would be eligible to apply the F-IRB approach, if that approach is available in the local jurisdiction. In contrast, as stated above, exposures to corporates belonging to consolidated groups with total assets greater than €50 billion must apply the Standardized Approach, regardless of total annual revenues.

- **Permit only the Standardized Approach, and the current IRB "supervisory slotting approach,"[6] for specialized lending exposures that use banks' estimates of model parameters.**

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[6] The supervisory slotting approach maps specialty lending exposures to one of five supervisory categories, each of which is associated with a risk weight.

Definition of Specialty Lending. Specialty lending includes project finance, object finance, commodities finance, income-producing real estate and high volatility commercial real estate.

- **Impose a floor to the internal model method for counterparty credit risk based on a percentage of the applicable Standardized Approach; remove internal models approach to the Credit Valuation Adjustment ("CVA") framework.**

Basis for Floors. For derivatives transactions, the floor would be based on the recently finalized standardized approach to counterparty credit risk (SA-CCR). For securities financing transactions, including repo and securities lending/borrowing, the floor would be based on the revisions to the standardized approach to credit risk proposed by the Basel Committee in December 2015.[7]

CVA Framework. The Consultation would force banks to use either the standardized approach for CVA or the "basic" CVA framework.

II. PARAMETER FLOORS

The IRB approaches generally require banks to estimate defined parameter inputs in order to calculate their credit risk-weighted assets. For those exposures where an IRB approach is still available (*i.e.*, those that are not limited to the Standardized Approach under Section I above), the Basel Committee is proposing to apply floors to certain of these parameters (probability of default ("PD"), loss given default ("LGD") and credit conversion factors ("CCF")) in order to reflect its judgment of an appropriate level of conservatism. The proposed parameter floors, at least some of which the Basel Committee suggests may increase after a quantitative impact study it intends to perform this year, are summarized in the following excerpt from the Consultation:

[7] These revisions would revise the long-standing "collateral haircut approach" and introduce an approach that better accounted for diversification and correlation between long and short positions.

Proposed parameter floors — Table 2

	PD	LGD		EAD/CCF
		Unsecured	Secured	
Corporate	5bps	25%	Varying by collateral type: • 0% financial • 15% receivables • 15% commercial or residential real estate • 20% other physical	EAD subject to a floor that is the sum of (i) the on balance sheet exposures; and (ii) 50% of the off balance sheet exposure using the applicable CCF in the standardised approach
Retail classes:				
Mortgages	5bps	N/A	10%	
QRRE transactors[12]	5bps	50%	N/A	
QRRE revolvers	10bps	50%	N/A	
Other retail	5bps	30%	Varying by collateral type: • 0% financial • 15% receivables • 15% commercial or residential real estate • 20% other physical	

The LGD and EAD floors are only applicable in A-IRB approaches. The EAD floors are for those exposures where EAD modelling is still permitted; see Section 4.3.

The LGD floors for secured exposures apply when the exposure is fully secured (ie the value of collateral after the application of haircuts exceeds the value of the exposure). The LGD floor for a partially secured exposure is calculated as a weighted average of the unsecured LGD floor for the unsecured portion and the secured LGD floor for the secured portion.

Comparison with Current U.S. Capital Rules. Under the advanced approaches of the current U.S. regulatory capital rules, PD for wholesale obligors and retail segments are generally subject to a floor of three basis points. Fitch reports that raising the floor for retail mortgages to five basis points could increase risk weights on these portfolios by 50 percent if all else remains equal.[8] Similarly, LGD for segments of residential mortgage exposures are subject to a floor of 10 percent.

QRRE Transactors and Revolvers. The Consultation introduces a distinction between qualifying revolving retail exposures ("QRRE") that are "transactors" and those that are "revolvers." This distinction is not made in the current Basel framework. QRRE transactors are defined as facilities, such as credit cards and charge cards, where the balance "has always been repaid at each scheduled repayment date and that at least six months have passed since the facility was first used as a means of payment."

[8] *See* Press Release, Fitch Ratings, Less Model Reliance Should Reduce Bank Ratio Variation (Apr. 4, 2016), *available at* https://www.fitchratings.com/site/fitch-home/pressrelease?id=1001935.

III. PARAMETER ESTIMATION PRACTICES

The Consultation proposes to limit the range of practices regarding the estimation of model parameters under the IRB approaches. Specifically, the Consultation proposes to introduce a variety of quantitative and qualitative restrictions on the estimation of:

- **Probability of Default.**

The Consultation seeks to limit the range of practices that banks use to estimate PD by introducing limitations on rating system design, specifying minimum standards for use of data and requiring a certain level of granularity for PD estimation. The Consultation also removes seasoning as an element of PD adjustment, instead converting it to a risk factor.

- **Loss Given Default.**

The Consultation provides detailed guidelines for calculating fixed supervisory-specified LGDs under the F-IRB approach (including for unsecured, partially secured and fully secured corporate exposures) and floors for bank-modeled LGDs under the A-IRB approach (including for unsecured, partially secured and fully secured corporate and retail exposures).

- **Exposure at Default ("EAD") and Credit Conversion Factors.**

The Consultation proposes to eliminate CCF modeling under the F-IRB approach and prescribes constraints on CCF and EAD modeling under the A-IRB approach. The Consultation also proposes to bring the IRB approaches in line with the recently proposed revisions to the Standardized Approach by clarifying that unconditionally cancelable commitments must be considered "commitments."

- **Maturity.**

The Consultation would require banks to determine maturity under the A-IRB approach based on the expiry date of the facility rather than the repayment date of a current drawn amount. The Basel Committee is not proposing to change the fixed 2.5 year maturity assumption under the F-IRB approach.

- **Credit Risk Mitigation.**

The Consultation proposes a number of technical amendments to the Credit Risk Mitigation framework that are not described herein.

IV. INTERACTION WITH OTHER INITIATIVES

As mentioned above, the Consultation is a part of a larger Basel initiative to reevaluate the calibration of the Basel III regulatory capital framework. It is important to remember that, although certain aspects of the Consultation would impose floors on parameters used in the capital calculation, the Consultation is separate from an upcoming consultation by the Basel Committee to introduce a capital floor. Specifically, the Basel Committee is considering whether to introduce a floor on IRB credit risk-weighted assets based on a percentage (*e.g.*, 60%-90%) of risk-weighted assets as calculated under the Standardized Approach. Similarly, although the Consultation does not discuss limitations on the IRB approaches' treatment of sovereign exposures, the Basel Committee has indicated that it is currently reviewing that approach in the context of a larger review of the capital treatment of sovereign exposures.

As discussed above, the Consultation represents an effort by the Basel Committee to migrate away from internal models, which it views as a primary source of unnecessary variation in risk-weighted assets among banking organizations. Even accepting the Basel Committee's assertion that the Consultation (along with other upcoming IRB-targeted consultations) is not intended to increase overall capital requirements, these initiatives likely will affect the distribution of risk-weighted assets at many institutions (primarily non-U.S. banks, for the reasons discussed above). Thus, the bottom line is that the proposal, if implemented in various jurisdiction, almost certainly will have a measurable impact on at least some banking organizations' capital requirements.

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Please do not hesitate to contact us with any questions.