ARTICLE

RISK AND COMPLIANCE

BASEL IV: COMING IF YOU'RE READY OR NOT

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Introduction: All change for the next Basel Accord

In 1988, the Basel Committee on Banking Supervision (BCBS) published the first Basel Accord: a set of minimum capital requirements for the world's banks, which would later become known as Basel I. Since these requirements were eventually enforced, in 1992, with the first market risk amendment in 1995, successive versions of the Accord have emerged with growing frequency.

In a drive to establish more consistent capital management standards, proposals for Basel II followed nearly a decade later in 2001 and, following many rounds of consultation with the industry, finalized in 2004. But by the time most major economies had implemented Basel II, in 2008, the global financial crisis was already taking hold. As a direct result, hot on the heels of its predecessor, came a further market risk amendment (Basel 2.5) in 2009 and then Basel III: proposed in 2009, finalized in 2011 and implemented from the start of 2013.

Now, as 2015 draws to a close, the BCBS has the next set of significant regulatory changes well within its sights. As the Accord's evolution gathers pace, could Basel IV already be on its way?

Denominator decisions on risk-weighted assets

In December 2014, at the RiskMinds conference in Amsterdam, the BCBS communicated the status of its capital and leverage regulations. Most aspects of the net stable funding ratio and liquidity coverage ratio had, or have since, been finalized: no further changes required. Work on the leverage ratio is now also almost complete, with only the final decisions on calibration to be made. One area, however, is still a major focus of work and attention: risk-weighted assets (RWAs), the denominator of the risk-weighted capital ratio.

To calculate their risk-weighted capital ratio, banks must divide their equity (the ratio's numerator) by their total RWAs. But RWAs must themselves be broken down into six types of risk: credit risk, market risk, operational risk, counterparty credit risk (including CVA Risk), securitization and interest rate in the banking book. Each of these risk types, in turn, carry its own distinct regulatory capital (Pillar 1 and Pillar 2) requirements – and it is to these requirements that important changes are being planned.

Capital and leverage regulations – status

	RISK-WEIGHTED CAPITAL RATIO	LEVERAGE RATIO	NET STABLE FUNDING RATIO	LIQUIDITY COVERAGE RATIO
Numerator	Finalised	Monitoring	Finalised (ASF)	Finalised (HQLA)
Denominator	Ongoing work	Finalised	Finalised (RSF)	Finalised (net stressed cash outflow)
Disclosure	Near finalisation	Finalised	Near finalisation	Finalised
Calibration	Finalised	Ongoing work	Finalised	Finalised

Framework published · Consultation in progress · Change previewed but no more

Capital and leverage regulations – RWAs

CREDIT RISK	MARKET RISK	OPERATIONAL RISK	COUNTERPARTY CREDIT RISK	SECURITISATION	INTEREST RATE RISK IN THE BANKING BOOK
Standardised approach	Fundamental review of the trading book (FRTB)	Revised standardised approach	Standardised approach to counterparty credit risk (SA-CCR)	Revised securitisation framework	Review exisitng treatment: Pillar 1 and Pillar 2 options
Revisions to the IRB approach		Review the advanced measurement approach	Review CVA charge	Simple transparent and comparable securitisations	
Simplicity, risk sensitivity and comparability Reducing variability in risk weighted assets					

Framework published ■ Consultation in progress ■ Change previewed but no more

Standard risk weights versus internal models

Before looking at these proposed changes in more detail, it's worth highlighting the common theme that runs through them. In a choice introduced by Basel II, banks can base their RWA calculations on either standard risk weights, as defined by national regulators, or internally developed risk models – which regulators must approve in advance. As it takes time, money and resources to not only gain but also maintain regulatory approval for internal models, only the largest banks tend to apply. The rest will typically stick to the standardized approaches.

At a speech in Madrid in November 2015, BCBS Chairman Stefan Ingves confirmed the importance of rethinking current approaches to both RWA calculations and internal model development. He admitted that the regulatory framework "has remained unchanged from Basel II across two broad dimensions: first, the way in which risk is measured – and in particular, the reliance on banks' own estimates of risk – has remained the same following the crisis; and second, the riskweighted approaches are essentially the same as they were before the crisis. The main elements of the Committee's ongoing policy reform agenda addresses fault lines that emerge from these two dimensions."[1]

The case for Basel IV

The ink may barely be dry on Basel III, but the BCBS seems intent on making fundamental changes to standard risk weights across the majority of risk types. Analyzed separately, each revision could be seen as an incremental shift, just the start of the journey towards a new Basel Accord.

When viewed in combination, however, a bigger picture starts to emerge – building a clear and compelling case for the imminent coming of Basel IV.

Exhibit #1: Credit risk

The story so far
From Basel II (2004) until 2014, the credit risk capital framework has undergone only limited changes. Basel II gave banks the option to use either an internal ratings based (IRB) approach or standard risk weights, based on customer type and external risk ratings from agencies such as Moody's, Standard & Poor's and Fitch Group. Traditional lending risk didn't play a major role in the financial crisis and so was not a key focus of Basel III. But the politicians and regulators did identify banks' overreliance on external risk ratings as contributing to the crisis. To address its concerns about this, the BCBS published a consultative document, Revisions to the Standardised Approach for credit risk (BCBS 307), in December 2014.

What's new?
BCBS 307 proposed to revise the standardized approach to credit risk capital management and essentially stop banks relying on external ratings. Having been consulted, however, the industry responded unfavorably to the proposals. A second consultation document was published in December 2015 reintroducing external ratings in a limited capacity with an alternative approach for use where external ratings are not allowed.

[1] STEFAN INGVES – FROM THE VASA TO THE BASEL FRAMEWORK (SPEECH AT THE 2015 ANNUAL CONVENTION OF THE ASOCIACIÓN DE MERCADOS FINANCIEROS

Exhibit #2: Market risk

The story so far
Shortly after the financial crisis, in 2009, the BCBS published Basel 2.5, which introduced a stressed value at risk (VaR) measure to increase the capital required for market risk management. But this didn't really improve risk sensitivity and failed to address key problems with Basel II's market risk framework: its underestimation of correlation risk between assets and varying degrees of liquidity of those assets. Consequently, in May 2012, the BCBS issued the consultative document Fundamental review of the trading book (FRTB).

Following industry feedback, further FRTB consultative documents were published in October 2013 and December 2014, with further changes set out in the instructions for an impact study on the proposed frameworks for market risk and CVA risk in July 2015. A finalized framework is expected in January 2016.

What's new?
FRTB introduces a more risk-sensitive standardized approach to calculating market risk capital, known as the sensitivity based approach (SBA). Meanwhile, for the internal models approach (IMA) to market risk, the BCBS has recommended moving from a VaR methodology to an Expected Shortfall calculation with adjustments for liquidity horizons and a proposal for Non-modellable Risk Factors. Even when a bank has gained approval for using an IMA, it will still be required to disclose its standardized capital ratio for market risk under the SBA.

Exhibit #3: Operational risk

The story so far
Requirements for calculating operational risk capital were first introduced in Basel II. These gave banks the choice between three very similar standardized (or simpler) approaches and an advanced measurement approach (AMA).

What's new?
For ten years after the finalization of Basel II, the BCBS made no further changes to its operational risk framework. In fact, operational risk wasn't even mentioned as a topic in Basel III. Then October 2014 saw the publication of the consultative document Operational risk – Revisions to the simpler approaches. Furthermore, Bill Coen, secretary-general of the Basel Committee, is reported to have said that BCBS will publish a consultation in December 2015 on whether to remove the AMA entirely.

Exhibit #4: Counterparty credit risk – default risk

The story so far
Counterparty credit risk (CCR) arising from the exposure that results from derivatives and securities finance trading has seen much recent attention from the BCBS. In addition to the existing standardized approach, Basel II introduced an internal model method (IMM) for calculating CCR capital. Following the crisis, the IMM requirements were heavily reinforced by Basel III and a new credit valuation adjustment risk (CVA Risk) capital charge introduced.

What's new?
Since Basel III, of all the risk types, the BCBS has made most progress on revising the standardized approach to CCR. First, in July 2013, it published a consultation on a "non-analytic" counterparty exposure measurement, the non-internal model method (NIMM). Then in March 2014 it published BCBS 279: a finalized version of the standardized approach for measuring counterparty credit risk exposure, now abbreviated to SA-CCR. The BCBS deadline for implementing SA-CCR is set for January 2017 but most jurisdictions appear to be going to miss this date.

Exhibit #5: Counterparty credit risk – CVA risk

The story so far
As previously mentioned, the CVA Risk capital charge was introduced in Basel III, in December 2010. Having been developed in something of a hurry, implementation details of the charge were heavily criticized by the industry, which noted its disparity from accounting CVA standards and failure to recognize market risk hedges.

What's new?
In July 2015, the BCBS proposed to fix these and other issues in its comprehensive Review of the Credit Valuation Adjustment Risk Framework. This consultative document aligns the advanced approach to CVA Risk with the FRTB approach to market risk including recognition of market risk hedges and accounting practices, together with a revised standardized approach.

Exhibit #6: Interest rate risk in the banking book

The story so far
Basel Accord rules on interest rate risk were a key part of the Basel I framework and have remained the same since 1988. That said, in 2004, the BCBS did issue new guidelines in its Principles for the management and supervision of interest rate risk. While this document didn't revise the rules per se, it did change the way they were supervised – explicitly giving national regulators the responsibility for setting the minimum level of the capital charge under Pillar 2.

What's new?
Interest rate risk wasn't covered explicitly by either Basel II or Basel III but changes are now, finally, afoot. In June 2015, the BCBS published Interest rate risk in the banking book: a consultative document that recommends a new standardized approach to interest rate risk capital management with either an explicit Pillar 1 charge or a more prescriptive Pillar 2 charge.

Exhibit #7: Capital floors

The story so far
Until now, any revision to a standardized approach would mean little to a bank that uses approved internal risk models. This may all be about to change, as across the risk types there has been widespread concern from regulators that banks may use their internal models to "game" the regulatory capital system. In other words, there is potential for organizations to manipulate their models, produce lower numbers and improve their Tier 1 capital ratio. To limit these benefits, the BCBS is now proposing a framework of capital floors.

What's new?
In December 2014, the BCBS published the consultative document Capital floors: the design of a framework based on standardised approaches. This suggested imposing minimum capital requirements on banks that use internal models, by setting floors as a percentage of the relevant standardized approach. No matter what the internal model recommends, the RWA value can fall no further than that percentage of the standardized total.

To date, the BCBS has been vague about how capital floors will be calibrated. No percentages have been confirmed; nor is it known whether floors will apply at the level of individual risk types or at an enterprise level. In any case, banks using internal models would need to disclose the impact of the floor on their capital ratios. Unsurprisingly, the industry response so far has been less than enthusiastic. But should capital floors become law, their standardizing impact on internal models could help shape a new regulatory era – for better or worse – and define the nature of Basel IV.

Conclusion: More than a sum of its parts – why regulatory change could add up to Basel IV

With revised standardized approaches for most risk types, and a proposed framework of capital floors, the Basel Committee looks set to make a philosophical, if not fundamental, change to the way banks calculate regulatory capital. Dig a little deeper into the organization's thinking, and you'd be forgiven for suspecting that risk sensitivity is no longer the highest priority.

As a precursor to its capital floors consultative document, the BCBS set out its stall in the 2013 publication The regulatory framework: balancing risk sensitivity, simplicity and comparability (BCBS 258). Two years on and the emphasis has shifted: in his aforementioned November 2015 speech in Madrid, Stefan Ingves talks more than once of balancing "simplicity, comparability and risk sensitivity", in that order.

Has risk sensitivity slipped down the regulatory agenda for good? Or has the BCBS recognized that, in the complex world of capital markets trading, simplicity and sensitivity can never be perfectly balanced? Certainly the industry is concerned that sensitivity will suffer at the hands of standardization. In a joint response to the initial capital floor proposals, major banks have already expressed the view that capital floors are "blunt capital measures"[2], which are driving them towards standardized approaches and could severely hamper risk sensitivity.

Whatever stance you take, I believe the apparent new emphasis on simplicity over sensitivity lies at the heart of the BCBS's latest round of RWA-related changes. In isolation, each of these revisions may not merit a new Accord. But together – and especially when underpinned by capital floors – they represent a subtle but significant new direction for the regulator. Only time will truly tell how quickly they lead to Basel IV.

[2] THE ASSOCIATIONS – LETTER TO MR WILLIAM COEN, SECRETARY GENERAL, BCBS, 27 MARCH 2015

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