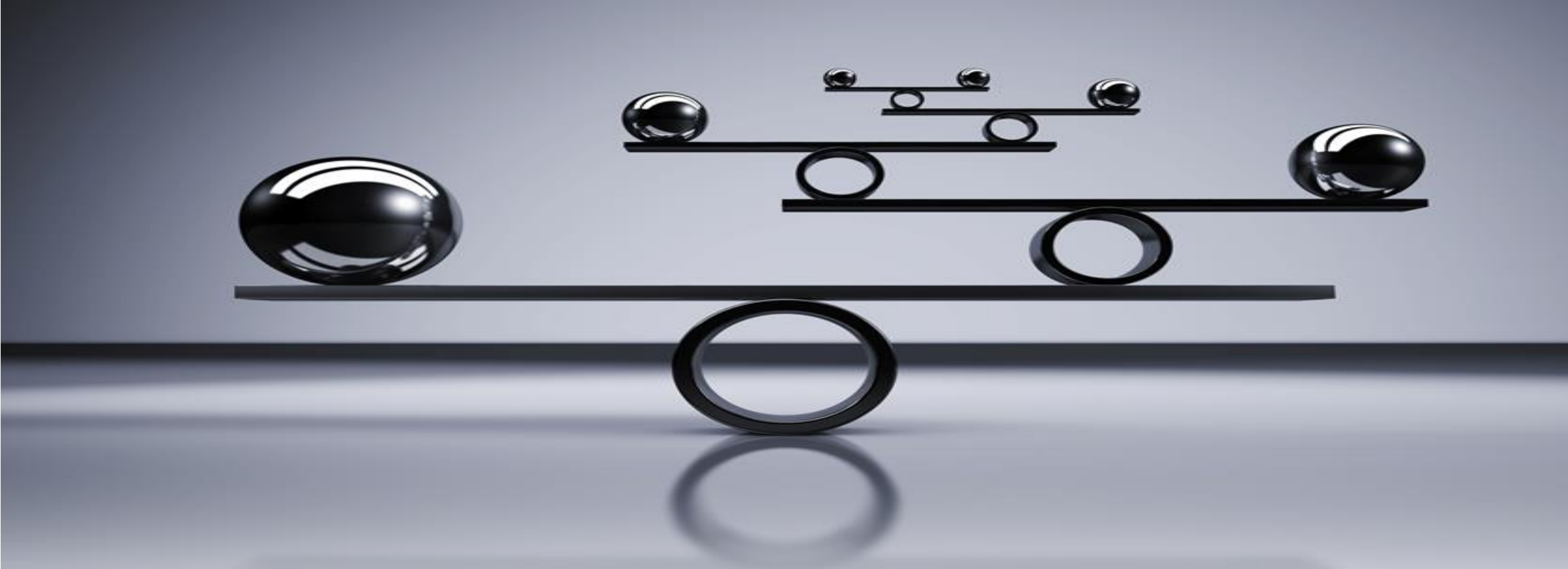
Further Details On “Request For Comment: Risk-Adjusted Capital Framework Methodology,” January 2024



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Agenda

1. Background
2. Proposed Changes To The Existing Criteria
3. Any Rating Impact Is Highly Unlikely
4. RFC Process
5. Appendix

Background

RFC: Comment Period Runs Until Feb. 26, 2024

Request For Comment: Risk-Adjusted Capital Framework Methodology

FAQ- What's Behind The Proposal To Update Our Risk-Adjusted Capital Framework Methodology?

S&P Global Ratings — RatingsDirect®

Criteria | Financial Institutions | Request for Comment:

Request For Comment: Risk-Adjusted Capital Framework Methodology

January 25, 2024

S&P Global Ratings is requesting comments on a proposed revision to the treatment of market risk in its "Risk-Adjusted Capital Framework Methodology" (RACF; published on July 20, 2017) based on emerging Basel III framework changes. These criteria constitute S&P Global Ratings' global framework for evaluating the capital adequacy of banks and certain nonbank financial institutions and financial services companies (including nonoperating holding companies of such groups). In this article, we refer to all these entities collectively as "financial institutions." The current criteria remain in effect until we finalize these proposed criteria.

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KEY CHANGES

Market Risk On Trading Activities

- We're proposing to update the current Paragraphs 111, 114, and 122 of the RACF to address recently implemented Basel III changes for reporting market risk on trading activities.
- The Basel changes include the introduction of the sensitivities-based and simplified standardized approaches, which we propose to address by adding new paragraphs and a table after Table 10.
- We're not proposing any changes to our methodology for prior regulatory approaches, such as Basel 2.5.

Revised Approach For Jurisdictions That Exempt Some Asset Classes From The Regulatory Credit Valuation Adjustment (CVA) Charge

- We propose to apply a multiplier based on the average proportion of nonexempted counterparties from a large sample of banks but to apply a bank-specific multiplier when we believe it could be material to our analysis. This proposal would result in us updating Paragraphs 87 and 88 of the criteria while deleting Paragraph 89.
- We propose to update the current Paragraph 92 to address the recently implemented Basel III fallback approach for computing the regulatory CVA charge.

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Credit FAQ:

What's Behind The Proposal To Update Our Risk-Adjusted Capital Framework Methodology?

January 25, 2024

S&P Global Ratings has published a request for comment (RFC) on its proposed revision to "Risk-Adjusted Capital Framework Methodology," published July 20, 2017 (RACF methodology). For details on this proposal, see "Request For Comment: Risk-Adjusted Capital Framework Methodology," Jan. 25, 2024. Below we address why we published the RFC at this time and answer questions about our analytical rationale and the RFC process.

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QUESTIONS AND ANSWERS

Why is S&P Global Ratings proposing changes to its RACF methodology?

We're proposing to update specific sections in our RACF methodology because some regulators are starting to implement the revised Basel III capital requirements. The revisions are intended to enhance the method by which financial institutions capture market risk through a sensitivities-based approach--including the use of 'Expected Shortfall' metrics instead of value-at-risk (VaR) metrics--as well as the risk of posting additional provisions due to the deterioration of the creditworthiness of derivative counterparties (credit valuation adjustment risk). In recent months, Korean and some Japanese banks have implemented the revised Basel III reporting for these risks, with Canadian banks scheduled to apply this reporting as of the period ending Jan. 31, 2024. In addition, banks in other jurisdictions--such as the U.K. and the EU--are planning to implement the revised Basel III requirements in the coming years. Our current criteria don't provide a multiplier to apply to the revised Basel III regulatory calculations to align with the one-year horizon and 99.9% confidence level that underpin our RACF criteria, and they're based on VaR metrics rather than expected shortfall disclosures.

How is S&P Global Ratings' analysis addressing these Basel III changes?

RFC: Why Now?

- Some regulators are starting to implement revised Basel III capital requirements.

- The revisions enhance the methods by which banks calculate risk-weighted assets for:
  - Market risks on trading activities; and
  - Risk of posting additional provisions due to a deterioration of creditworthiness of derivative counterparties, absent default, known as credit valuation adjustment (CVA) risk.

- In recent months, Korean, Japanese, and Canadian banks have implemented or are implementing the revised Basel III capital requirements, with some already reporting regulatory capital ratios calculated under the new framework. Other jurisdictions will follow.

- We're proposing changes to RACF because the current criteria don't provide a multiplier to apply to the revised Basel III regulatory calculations for market risk on the trading book and CVA.

- Our criteria are not affected by the other Basel III reporting changes. This is because our RAC charges for other risks are derived by multiplying risk exposures by our defined risk weights (as opposed to the approach of applying a multiplier to the outcome of the regulatory calculation, which we use for market risk on the trading book and the CVA).

Proposed Changes To The Existing Criteria

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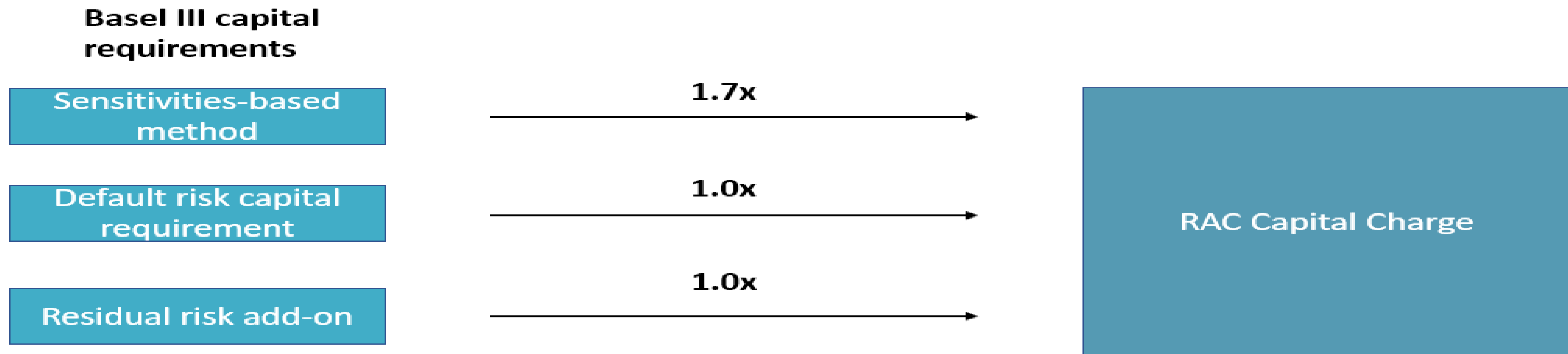
Key Changes – Market Risk On Trading Activities

- We're proposing the following multipliers for banks implementing the standardized sensitivities-based approach under revised Basel III reporting:



- The **1.7x** multiplier, which will change as market conditions warrant, is based on analytical judgement. We looked at available disclosures from a representative sample of banks in the context of the Basel III framework, and we calibrated the charges to a one-year 99.9% VaR consistent with RACF. (See the Appendix for more details.)
- We propose a **1.2x** multiplier for the simplified standardized approach.
- We propose no change to the multiplier for entities reporting under prior approaches, such as Basel 2.5.

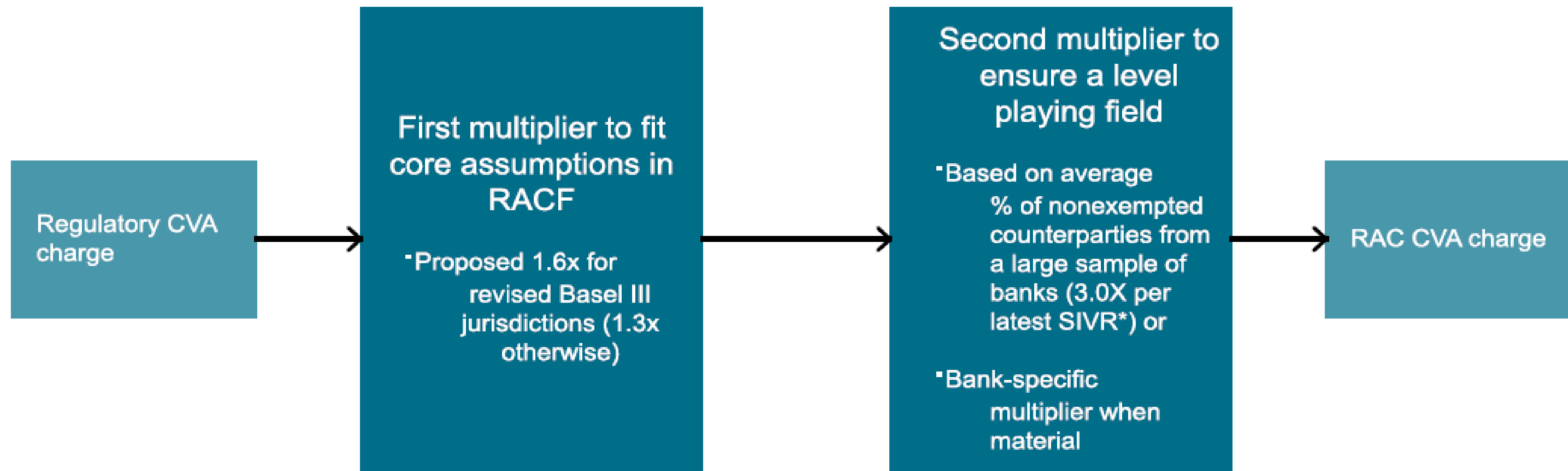
Key Changes – Credit Valuation Adjustment (CVA)

- Consistent with how we scale the CVA charge to our one-year 99.9% confidence level under our current criteria, we plan to update our Sector & Industry Variables Report (SIVR) for banks applying the revised Basel III standardized or basic approach with a **1.6x multiplier** to the regulatory CVA charge (see the Appendix for more details). We will continue to apply a 1.3x multiplier for banks that have not yet implemented the revised Basel III standards.

- For banks applying the revised Basel III fallback approach (i.e., with a regulatory CVA charge equivalent to the capital requirement for counterparty risk) and that are above the thresholds defined in our criteria, we propose to compute the RAC CVA charge as a percentage of derivatives receivables, with multipliers that we've calibrated by looking at a set of representative banks. (This is same as the approach under our current criteria for a bank that does not report a regulatory CVA.)

Key Changes – When Some Asset Classes Are Exempted From Regulatory CVA

- In addition to the proposed changes resulting from the revised Basel III disclosures, we're proposing a modified approach for calculating the second multiplier for jurisdictions (such as the EU) that have exempted some asset classes from the regulatory CVA charge.



*"Sector And Industry Variables: Risk-Adjusted Capital Framework Methodology," March 31, 2023.

- This differs from the current approach of applying a bank-specific multiplier even if we believe it may not be material to our analysis.

Any Rating Impact Is Highly Unlikely

Rating Impact: Highly Unlikely

- The proposed changes target a limited aspect of the RACF criteria that only apply to banks using revised Basel III reporting.

- The proposal to calibrate trading and CVA risk to a one-year horizon and 99.9% VaR confidence level is consistent with our approach applied to Basel 2.5 and prior regulatory regimes.

- We recognize that upon transition to the revised Basel III framework, the output of the RACF criteria -- the risk-adjusted capital (RAC) ratio -- could materially affect a small number of banks. Nevertheless, we believe any rating impact is highly unlikely because our financial institutions rating methodology considers the RAC ratio in conjunction with the risk position assessment, which specifically addresses factors not already captured in the capital and earnings assessment.

- We similarly don't expect any rating impact for other entities that apply all or elements of the RACF criteria, such as non-bank financial institutions, multilateral lending institutions, or public-sector funding agencies.

RFC Process

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RFC Response Deadline

- We encourage interested market participants to **submit their written comments** on the proposed criteria **by Feb. 26, 2024**, to https://disclosure.spglobal.com/ratings/en/regulatory/ratings-criteria, where participants must choose from the list of available Requests for Comment links to launch the upload process (you may need to log in or register first).

- Comments may also be sent to CriteriaComments@spglobal.com should participants encounter technical difficulties. All comments must be published, but those providing comments may choose to have their remarks published anonymously or they may identify themselves. Generally, we publish comments in their entirety, except when the full text, in our view, would be unsuitable for reasons of tone or substance

- We will review and take such comments into consideration before publishing our definitive criteria once the comment period is over.

Thank You - Any Questions, Please Feel Free To Contact Us

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Appendix

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Assumptions applied in developing our proposal

- The standardized sensitivities-based and internal model regulatory calculations for market risk, though different in the application of bank-specific assumptions, are calibrated consistently for confidence levels and liquidity time horizons. This supports our assumption that the regulatory charges are calibrated to a 97.5% expected shortfall and varied liquidity horizons by asset and sub-asset classes.

- The proposed 1.7x multiplier applied to the sensitivities-based method converts the regulatory confidence levels and liquidity time horizons to the one-year horizon and 99.9% VaR confidence level underpinning our RACF criteria. Our proposed multiplier was derived from our analytical judgement based on assessing available data from a representative sample of major banks with meaningful trading activities. We propose that the multiplier will be updated periodically as market conditions warrant. Our one-year liquidity horizon assumption is supported by our belief that although some trading positions can be quickly unwound, they would likely be replaced by new trading positions as the bank continues to take risks to support its income-producing activities.

- The proposed 1x multiplier to default risk under the Basel III standardized approach is consistent with the Basel III assumptions of a one-year holding period and a 99.9% level. The proposed 1x multiplier to the Basel III standardized approach residual add-on risk reflects that the regulatory charge is anticipated to be less than 5% of the total charges.

- The proposed 1.2x multiplier for banks applying the Basel III simplified standardized approach recognizes that the Basel calibration is consistent with the prior Basel standardized approach except for the scalars to the calculated charge.

- Our proposed 1.6x multiplier for CVA risk for banks applying the revised Basel III standardized or basic approach applies a similar approach to the sensitivities-based method, given that the same underlying principles are applied to the regulatory calculation.

Related Publications

Related Request For Comment

- Request For Comment: Risk-Adjusted Capital Framework Methodology, Jan. 25, 2024
- What's Behind The Proposal To Update Our Risk-Adjusted Capital Framework Methodology?, Jan. 25, 2024

Other Research on Basel Developments

- Credit FAQ: How the U.S Proposes to Implement Basel III Capital Rules And The Impact on U.S Bank Capital Ratios, Jan. 11, 2024
- EU Banking Package: Inconsistencies Temper Framework Improvements, Jan 09, 2024
- Basel III Bank Capital Rules in Europe: Delayed and Diluted, Oct. 28, 2021
- The Basel Capital Compromise For Banks: Better Buffers, Elusive Comparability, Jun 03, 2021