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Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework

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Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework

*(**Editor's Note:** We originally published this criteria article on June 22, 2012. We're republishing it following our periodic review completed on June 5, 2014. This article supersedes paragraphs 81 to 86 in "Bank Capital Methodology And Assumptions," published Dec. 6, 2010.)*

1. Standard & Poor's Ratings Services is refining its methodology and assumptions for computing market risk charges for banks in its risk-adjusted capital framework (RACF).

2. This article provides the detailed criteria we use to assess risk-weighted assets (RWA) for banks' trading book exposures in our RACF. We are also adapting the charges we apply to market risk exposure for banks that are domiciled in jurisdictions subject to the Basel 2.5 regulatory framework (hereinafter Basel 2.5 jurisdictions) and have regulatory-approved internal market risk models.

3. This article is related to our criteria article "Principles Of Credit Ratings," published Feb. 16, 2011, on RatingsDirect on the Global Credit Portal.

SCOPE OF THE CRITERIA

4. The revised methodology applies to all the entities within the scope of our RACF criteria (see paragraph 4 of "Bank Capital Methodology and Assumptions").

SUMMARY OF THE CRITERIAUPDATE

5. This article provides the detailed criteria we use to assess risk-weighted assets (RWA) for trading book exposures of banks within the scope of our RACF. The criteria are applicable to banks in all jurisdictions, whether they have regulatory-approved market risk models or not.

6. We have revised some of the assumptions we use to calculate RWA following improved disclosure about trading book exposures in banks' Pillar 3 reports under the new Basel 2.5 framework. These changes affect only banks that are domiciled in Basel 2.5 jurisdictions and have regulatory-approved internal market risk models.

7. Notable changes include:

- Applying a 1.5 multiplier to the value-at-risk (VAR) and the stressed value-at-risk (SVAR) regulatory charges;
- Applying a 1.0 multiplier to the incremental risk charge (IRC) and to the comprehensive risk measure (CRM); and
- Aligning RAC charges to securitization positions in banks' trading books with those for similar exposures in the banking books.

IMPACT ON OUTSTANDING RATINGS

8. We expect few, if any, rating actions following the application of our revised market risk charges. Our RAC ratios (before diversification) will likely remain broadly unchanged for banks with regulatory-approved internal market risk models in Basel 2.5 jurisdictions. For a few banks with large trading operations, we could lower our RAC ratios by more than 10 basis points. Any such decreases will depend on the nature of the banks' positions and the previous applicable Basel 2 regulatory charges. In rare instances, if any, a lower RAC ratio could result in a downward revision of our assessment of a bank's capital and earnings of a sufficient magnitude that we could consider lowering the ratings on the bank.

EFFECTIVE DATE AND TRANSITION

9. These criteria are effective immediately.

METHODOLOGY

10. Our RAC market risk charges capture the risk of loss on a bank's trading portfolio at a one-year horizon and a 99.9% confidence level. This implies that, over a period of one year, trading losses should be statistically below the RAC market risk charges in 99.9% of the cases. We believe the one-year horizon reflects the illiquidity of many assets. This horizon also takes into consideration that, even if positions could be unwound in a matter of weeks, they would likely be replaced by new trading positions, as the bank continues to take risks to support its income-producing activities.

11. Our RAC market risk charges factor in both general risk (such as potential losses stemming from a change in interest rates or a variation in stock indices) and specific risk (such as the potential losses stemming from swings in credit spreads, or from rating migrations and defaults) at the chosen time horizon and confidence level.

Methodology for entities that have regulatory-approved internal market risk models but that are not domiciled in Basel 2.5 jurisdictions

12. For banks with VAR models validated for general risk only, we apply a 3.0 multiplier to the regulatory capital requirement figure. This is to align the VAR charge with a one-year horizon and make it consistent with a 99.9% confidence level. The multiplier includes a 50% add-on to account for extreme (fat-tail) events in a hypothetical portfolio consisting of equities, interest rate positions, commodities, and foreign exchange.

13. For banks with VAR models validated for both general and specific risk, we apply a 4.0 multiplier to the regulatory capital requirement figure. This higher multiplier, relative to that in the previous paragraph, reflects our assessment that migration and default risks are poorly captured in VAR specific risk models.

14. We apply a multiplier of 1.5 to the regulatory capital requirement figure if it is derived from the Basel standardized approach. This reflects our opinion that the standardized approach is typically more conservative than VAR models approved by regulators, particularly with regard to asset diversification.

Methodology for entities that are domiciled in Basel 2.5 jurisdictions and have regulatory-approved internal market risk models

15. We apply a multiplier of 1.0 to the IRC and CRM charges because they are already consistent with a one-year capital horizon and a 99.9% confidence level.

16. We apply a multiplier of 1.5 to the sum of the VAR and the SVAR charges in order to align the charges with our chosen capital horizon and confidence level. Unlike the 3.0 and 4.0 multipliers for banks that are not domiciled in jurisdictions subject to the Basel 2.5 regulatory framework (see paragraphs 12 and 13), this multiplier includes no add-on for fat-tail events. This is because, in our view, the regulatory stressed VAR already captures periods of significant stress.

17. Under our RACF, we multiply by 1.5 any regulatory charge that has been computed using internal models (including VAR, SVAR, IRC, and CRM) when the bank does not disclose which model or which combination of models it has used. We apply this multiplier in particular when the bank reports the total of the regulatory charge, computed according to internal models, without providing any breakdown by component.

18. In line with paragraph 14 above, the RAC capital charges we apply are 1.5 times the regulatory capital charges for positions outside the VAR model (and excluding securitization positions), which are treated according to the Basel standardized approach.

19. Paragraphs 20 to 24 describe the RAC capital charges we apply to a bank's securitization positions in its trading book, excluding correlation trading positions (which are included in the CRM charge).

20. When a bank discloses the breakdown of exposures by external ratings, the RAC risk weights we apply are in table 9 of "Bank Capital Methodology and Assumptions."

21. When a bank discloses the breakdown by regulatory risk weight range, we make a credit estimate for each risk weight range according to table 10 of "Bank Capital Methodology and Assumptions" and then use the RAC risk weight in table 9 that pertains to the credit estimate.

22. When a bank does not disclose the breakdown by external rating or by regulatory risk weight range, we apply a 1.5 multiplier to the regulatory charge.

23. Whenever the methodology in paragraphs 20 or 21 above applies, we cap the RAC charge at 1.5 times the regulatory charge, in order to ensure a level playing field for the relevant banks. This cap applies only to securitization exposures in the trading book that are not deducted from regulatory capital.

24. We apply a 1,250% RAC risk weight to securitization exposures in the trading book which are deducted from regulatory capital. This is consistent with our RACF treatment for securitization exposures in the banking book (see paragraphs 69 and 71 in "Bank Capital Methodology and Assumptions").

Entities with no approved market risk internal models for regulatory purposes

25. We apply a 1.5 multiplier to the regulatory capital requirement figure if it is derived from the Basel standardized approach. This is regardless of whether the entity is domiciled in a Basel 2.5 jurisdiction or not.

26. If the regulatory capital figure for market risk is not available, the market risk RAC charge is zero and we treat

securities in the trading book as if they were recorded in the banking book. For example, in our RACF we classify stocks as equity holdings in the banking book, corporate bonds as corporate exposures, collateralized debt obligations as securitization exposures, and the risk weights we apply are the same as those we apply to banking book exposures.

RELATED CRITERIA AND RESEARCH

- Bank Capital Methodology and Assumptions, Dec. 6, 2010
- Advance Notice of Proposed Criteria Change: Updating Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, May 14, 2012
- Basel 2.5 Increases The Squeeze Of Investment Banking Returns, May 14, 2012

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