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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.

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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,

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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.

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