White Paper

Basel III

An easy to understand Summary

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1. Executive Summary

Basel II was introduced in the year 2005 to address new risks which had arisen in the world of Banking. Credit Risk was enhanced to evaluate risk at client level for wholesale banking while Basel I evaluated it at a sector level. Banks were given the option to develop their own model for credit risk. There were no new guidelines on market risk but Banks had to provide capital for operational risk as it was seen as a new risk due to increased globalization, outsourcing and use of technology. In addition to the above, two new pillars were introduced to cover risks that were not covered by Pillar I and disclosure of capital adequacy was mandated by the regulators as per pillar III guidelines. A lot of emphasis was placed on independent verification of the ICAAP (Internal Capital Adequacy Assessment Process) which covered all risks not covered under pillar I and results of capital adequacy under stressed conditions.

However, the economic downturn resulting from huge downturn of ratings of sub-prime backed securities and collapse of some banking organizations led BIS (Bank of International Settlements) to strengthen the capital requirements for banks to prevent banks from collapse by taking excessive risks. These revised guidelines are referred to as Basel III. This document explains the changes introduced in Basel III and explains the concepts with some examples to increase understanding of the new guidelines and its impact on banks. The changes introduced under Basel III can be summarized as given below:

- Quality, Consistency and Transparency of Capital will be raised
- Risk Coverage of Capital framework will be strengthened
- Leverage ratio to be introduced as a supplementary measure to the risk framework
- Reducing procyclicality and promoting countercyclical buffers
- Introduction of Liquidity Coverage Ratio (short term) and Net Stable Funding Ratio for long term liquidity measure.

It must be noted that Basel III guidelines are still in the formative stage and not final. As it involves significant changes in the Bank's capital structure and risk management processes, there is a lead time of more than 6 years before everything will be implemented. Based on events and learning during the next 6 years, the guidelines will be continuously fine-tuned.

2. Overview

2.1 The Business Problem/Need

Basel II guidelines introduced in 2005 were found inadequate to handle risks taken by banks which led to the collapse of the banking system in 2008. Based on the learning and experience of the 2008 financial services industry crisis, there was a need to introduce modifications in the Basel II guidelines. BIS, the organization which issues the guidelines, studied the reasons for the collapse of the banking industry to introduce more controls in risks taken by banks thus ensuring that banking industry does not have a recurrence of the problem. The crisis arose because of three fundamental reasons:

- Excessive on and off-balance sheet leverage
- Erosion of the level and quality of capital
- Insufficient liquidity buffer in banks

2.2 The Business Goals and Benefits

The main business goal of Basel III is to have improved risk management processes for banks. This is achieved through improvement in quality of capital, introduction of countercyclical buffers, liquidity and leverage ratios and counterparty risk. This will ensure that banks have adequate funds for the business and ensure that excessive risk is eliminated for safety and security of customers and the banking industry in general.

2.3 Critical Success Factors

The critical success factor for Basel III is its implementation by banks around the world. At this moment of time, BIS is in the final stages of formulating its guidelines. The regulators in each country will have to analyse the impact of these changes in their jurisdiction and issue Basel II guidelines for their country. Each regulator will have to issue a deadline for implementation in their country. It is estimated by BIS that it could be the end of 2015 before all regulators issue guidelines and implement the new guidelines. The main issue will be raising good quality capital as it will have a price tag associated with it.

2.4 Assumptions and Restrictions

BIS is in the final stage of finalization of Basel III guidelines. This requirements document is based on the interpretation and understanding of the following documents issued by BIS:

- Basel III: A global regulatory framework for more resilient banks and banking system (December 2010 – revisions up to June 2011)
- Basel III definition of capital frequently asked questions (July 2011)
- Basel III: International framework for liquidity risk measurement, standards and monitoring
- Basel III framework for liquidity frequently asked questions

3. Current Process

3.1 Current Processes

Most Banks are already doing regular submissions of Basel II risk compliance as required by the local regulator for home and host reporting. These processes are based on the Basel II reporting guidance issued by the regulators under pillar III relating to disclosure by banks. The processes could be based on Standardized or Advanced methods depending on the reporting methodology prescribed by the regulator and adopted by the bank.

3.2 Current Limitations

The 2008 banking and financial crisis revealed a lot of weakness in the Basel II guidelines. BIS has tried to plug the weakness in the revised guidelines which is called as Basel III. The limitations were mainly in the area of quality of capital, liquidity, leverage and buffer capital requirement. Each regulator is expected to review the revised guidelines and either implements it in total or implement after making the required changes as per local requirements.

4. Description of Requirements

4.1 Required Business Processes

The new business processes will have to be compliant with Basel III requirements. Apart from implementing the basic operational and technology processes, adequate emphasis has to be placed on independent reviews and ensuring that the capital is maintained at the right level at the desired quality. The new processes will have to be overlaid on top of the existing Basel II processes as Basel III is an extension of Basel II and not a replacement of Basel II.

4.2 Business Scope

4.2.1 Business Groups

Basel III covers all business groups of Wholesale Banking, Retail Banking, Private Banking and Investment banking and their related exposure based products.

4.2.2 Business Product / Business Transaction Types

Basel III will cover all exposure based products (assets) where the banking is taking a risk or exposure. The exposure could be a counterparty credit default leading to credit risk or a speculative risk relating to taking positions in the market (could be FX, stocks, etc.). Operational risk will cover all products and not limited to asset based products. However there are no changes in operational risk and market risk in Basel III and the changes are limited to Credit risk, pillar II and Pillar III.

4.2.3 Primary Business Users

While all business units will be suppliers of base data for Basel III computations, the main users of the system will be risk management unit and regulatory reporting unit. While the Risk Management unit will be using it for managing risk effectively in the business, the regulatory reporting unit will be looking at it from a compliance perspective.

4.2.4 External impacts / Other Business groups affected

The local regulator will be reviewing the results of Basel II and auditing the periodic submission for correctness, compliance and risk taking ability of the bank in terms of its strategic plans. The regulator will also inspect its capital adequacy plan in terms of its strategic growth plans and its ability to raise the required capital to counter unexpected risks. Evaluation of stress test results will form a critical part of the review as that will enable the regulator assess the ability of the bank to handle downturns.

4.2.5 Implementation Considerations

The Basel III amendments are adjustments to the Basel II accord in reaction to the 2007-2008 economic crisis and not a major recast of Basel II requirements. As the recommendations involve some fundamental changes in capital requirements and will have severe impact on day-to-day business requirements, a long lead time has been given for implementation. Some of the changes are relatively easier and hence they have been given a shorter lead time for implementation. It must be noted that Basel III cannot be developed as a new standalone system – it is merely amendments to base Basel II system and not a new system on its own. All Banks will implement Basel III as add-on to the existing Basel II system.

If some data elements or functionality required for Basel III are not available in Basel II database, relevant modules can be added with an interface to the Basel II system to enable the required computations. As an example, if data elements required for computing liquidity ratios are not available, the ratios can be computed off line and fed as inputs into the Basel II system for overall reporting to the regulator. In section 4.3, where the requirements are described in detail, the implementation aspects in terms of changes to Basel II system or add-on systems are also described in yellow boxes. Examples are provided using the base data described in section 4.2.6.

4.2.6 Base Data

Basel III requirements are described in section 4.3. Implementation considerations for each requirement are described along with the description of the requirements. The general ledger (GL) and contracts/accounts that link to the general ledger form the base data for computing the new ratios. The following tags could be used on the General Ledger data to compute the ratios. The recommended flags are as follows:

Flag	GL Type	Values	Description
Capital	Liabilities	T1	Tier I Capital
		T2	Tier II Capital
		T1E	Common Equity (Part of Tier I)
Liquidity Flags	Asset	HL	Highly Liquid Assets
	Asset	HLAV	Highly liquid Assets which are recurring and hence available through the year
	Asset	AV	Not very liquid assets but can be liquidated in year
Outflow Flags	Liability	30D	Liabilities with outflows in next 30 days
	Expenses	PER	Periodic outflows over the year

4.3 Specific Business Requirements

The specific requirements are listed under four sections:

- Strengthening of Capital
- Global Liquidity Standard
- Risk Coverage
- Leverage Ratio

Unless specifically mentioned, all clause numbers referred in this section are clause numbers under the guideline,

Basel III: A global requirement framework for more resilient banks and banking systems.

It must be noted that this document explains the concepts of Basel III and actual implementation in each country will be based on regulatory guidelines published by the country.

4.3.1 Strengthening of Capital

The critical issue relating to capital were the following:

- Inconsistent definition of capital components in tier I, II and III
- No ratios prescribed by tiers
- No buffers for countercyclical situations

The changes were introduced to address the above issues.

a. Predominant form of tier I capital must be equity and retained earnings as this is high quality capital

b. Under Basel II, Tier 1 capital could have up to 15% of preferred stock or coupons with no maturity date and no incentive to redeem. This will be gradually reduced to zero and tier I will only comprise of common stock and retained earnings. This will result in improvement in quality of capital base.

c. One of the important factors leading to lack of stability was the procyclical amplification of financial shocks in the banking system. This was amplified through poor implementation of accounting standards for mark-to-market, margining and leveraging of assets. While the leverage ratio addresses part of this issue, the ability to absorb shocks in difficult times must be built at good times. This will protect the banking sector from periods of excess credit growth. The changes introduced include the following:

- Improved provisioning for better computation of expected loss.
- Capital Conservation and introduction of buffers to promote safety during periods of stress
- Recalibration of Probability of default and LGD at stress conditions called downturn LGD. While downturn LGD was introduced in Basel II, it was not implemented by most supervisors.
- Use of PD in IRB method based on an average of a complete cycle to average out stress conditions.

d. As the transition from Basel II to Basel III guidelines is focussed on strengthening the capital base, the transformation cannot be done instantaneously. The transformation has to be a phased approach and transitional eligibility of items under common shares; additional tier 1 and tier 2 are given in section 44-46 and 94-96. Applicability time frame of revised requirements is phased from January 1, 2013 to January 1, 2018 as described in sections 94-96.

e. All capital items are subject to regulatory adjustments. Regulatory adjustments mainly relate to common equity and must be reduced from capital. The regulatory adjustments are given in sections 67-90.

Key Points relating to changes in Capital from the revised guidelines

- Basel III Capital – Change in definition of Tier 1 capital and increased capital requirements.
  - Tier 1 capital has to predominantly consist of Common Equity.
  - Many components of current Tier 1 capital will be phased out.
  - New minimum capital ratios:

Components	Tier 1 Common Capital Ratio	Total Tier 1 Capital Ratio	Total Capital Ratio
Minimum	4.50%	6.00%	8.00%
Capital Conservation Buffer	2.50%	2.50%	2.50%
Total	7.00%	8.50%	10.50%

End State Ratios

Components	Tier 1 Common Capital Ratio (After all phase in / phase outs completed)	Total Tier 1 Capital Ratio	Total Capital Ratio
Minimum	4.50%	6.00%	8.00%
Capital Conservation Buffer	2.50%	2.50%	2.50%
Total	7.00%	8.50%	10.50%
Potential G-SIFI Buffer:	?	?	?
Countercyclical Capital Buffer range Must be comprised of common equity or other fully absorbing loss capital.	0 - 2.50%	0 - 2.50%	0 - 2.50%

- Changes in Definition of Capital and Capital Requirements phased in over 7 period from 2013 to 2020
  - Change in definition of Tier 1 capital and exclusion of (or limits on) various items from Tier1. Tier 1 capital must predominantly consist of Tier 1 common.
  - Capital conserving capital buffer and anti-cyclical capital buffer. Potential Global (Systemically Important Financial Institution) SIFI Buffer.
- Changes in the definition of capital
  - Tier 1 split into two components and has been redefined
    - Common Equity (a.k.a. Tier 1 common)
    - Additional going concern capital
  - Predominant form of Tier 1 should be Common Equity (retained earnings and common shares).
  - Tier 2 has been redefined.

- Limits and exclusion of a number of current components of Tier 1:
  - Up to 10% of common equity may consist of each of the following components, with a cumulative limit of 15% on all three components:
    - Deferred Tax Assets which rely on future profitability of the bank.
    - Mortgage Servicing Rights (MSRs)
    - Investments in capital of certain non-consolidated banking, financial and insurance entities:
      - If a bank owns more than 10% of institution's equity
      - If a bank's investment in institution exceeds 10% of its common equity
      - Rules must take into account equity in banking and trading book, but excludes underwriting positions..
  - Restricted use of hybrid securities
  - Other components currently included in Tier 1 will be phased out.
- Capital instruments that will be phased-out of Tier 1 common:
  - Stock surplus
  - Minority interest
    - This was modified in the July Annex to:

    The Committee will allow some prudent recognition of the minority interest supporting the risks of a subsidiary that is a bank. The excess capital above the minimum of a subsidiary that is a bank will be deducted in proportion to the minority interest share
  - Other Comprehensive Income (OCI)Adjustments
  - Goodwill and other intangibles (obviously, excluding the limits on DTAs, MSRs and investments in non-consolidated FIs)
  - Investments in own shares (treasury stock)
  - Shortfall of the stock of provisions to expected losses
  - Cash flow hedge reserve
    - Remove the positive and negative cash flow hedge reserve from the Common Equity
    - component of Tier 1 where it relates to the hedging of projected cash flows which are not recognized on the balance sheet.
- Capital instruments that no longer qualify as Tier 1 common:
  - Cumulative gains and losses due to changes in own credit risk on fair valued financial liabilities
  - Defined benefit pension fund assets and liabilities
    - Apply no filter to defined benefit pension fund liabilities.
    - Deduct the value of any defined benefit pension fund asset from the Common Equity component of Tier 1. Assets in the fund to which the bank has unrestricted and unfettered access can, with supervisory approval, offset the deduction. Such offsetting assets should be given the risk weight they would receive if they were owned directly by the bank.
  - Remaining 50:50 deductions

  All remaining regulatory adjustments which are currently deducted 50% from Tier 1 and 50% from Tier 2, and which are not addressed elsewhere in the proposal, should receive a 1250% risk weight.

  These include:

  Certain securitization exposures;

  Certain equity exposures under the PD/LGD approach;

  Non-payment/delivery on non-DvP and non-PvP transactions; and

  Significant investments in commercial entities.

- Regulatory Adjustments

Regulatory Adjustments are mainly related to Tier 1 items – common stock and other subordinated instruments that are classified by regulators as Tier 1. While the current regulations allow up to 15 percent of additional tier 1 items, it will be gradually phased out and tier 1 capital will be predominantly share capital and retained earnings. The regulatory adjustments defined in clause 67-90 must be applied on capital predominantly on common equity tier 1 capital.

- Goodwill and Other intangibles (except Mortgage servicing rights) must be deducted from Common equity tier 1 capital (67-68)
- Deferred Tax Assets (DTAs) which rely on future profitability of the bank are to be deducted from common tier 1 capital (69-70)
- Any cash flow hedge reserve which are not fair valued must be removed from tier 1 common equity capital (71-72)
- If there is a shortfall in provisions made for expected losses, it must be deducted from Common equity tier I capital. (73)
- Any tier 1 capital associated with sale of securitization transactions must be removed from tier 1 common equity capital (74)
- Cumulative gains and losses due to changes in own credit risk on fair valued financial liabilities (75)
- Defined benefit through pension fund liabilities must be fully recognized in the tier 1 common equity capital (76-77)
- Any investment by the bank in its own shares will be deducted from tier 1 common equity capital
- Reciprocal cross holdings of capital artificially inflate the capital and must be deducted when computing tier 1 equity capital.(78-83)
- Significant investments made in organizations which are outside the scope of regulatory consolidation must be deducted from capital tier 1 equity. (84-86)

Some of the above deductions may receive partial acceptance subject to a maximum of 10 percent of pure common equity as listed in section 87-90

Capital Buffers

- A "Capital conservation buffer", higher than their minimum capital requirement.
  - If Tier 1 capital was above the minimum but below the capital buffer various "capital conservation" rules would take effect to restrict selected cash flow payments, such as dividends or stock buybacks.
  - A "Countercyclical capital buffer" (as of July, 2010) which would be an add-on to the capital conservation buffer extending its range.
    - The add-on would normally be zero. Its magnitude would be determined by a macro-economic indicator which will measure the excess growth of credit relative to GDP in the economy.
    - In more detail, the proposal would require regulators to measure the ratio of Credit/GDP and compare that ratio to the TREND of that ratio over time. The magnitude of the "countercyclical capital buffer" will be determined by the degree to which the Credit/GDP ratio exceeds the trend.
  - The Basel Financial Stability Board is likely to require an additional capital buffer for Global SIFIs (Systemically Important Financial Institutions). Three things need to be specified in any proposed rule:
    - Criteria for categorizing a bank as a G-SIFI
    - Amount of additional buffer; and if buffer is variable criteria for amount.
    - Specifying eligible forms of capital for SIFI Buffer

Time table for Basel III changes

Annex 2: Phase-in arrangements (shading indicates transition periods)
(all dates are as of 1 January)

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Leverage Ratio	Supervisory monitoring		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
Minimum Common Equity Capital Ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer						0.625%	1.25%	1.875%	2.50%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)				20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.125%	9.875%	10.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital			Phased out over 10 year horizon beginning 2013						
Liquidity coverage ratio	Observation period begins				Introduce minimum standard				
Net stable funding ratio		Observation period begins						Introduce minimum standard	

4.3.1.1 Common Equity Tier 1 must be at 4.5% of Risk Weighted Assets (RWA)

Items eligible under Tier 1 of capital are listed under 52-53, 62 of BIS guidelines

The General Ledger of the Bank would have GLs marked as capital for Basel II computation. They were not differentiated into T1 (Tier I), T1E (Tier I Equity) and T2 (Tier 2) separately as there was no separate ratio for T1 and T2 respectively. As Basel III requires this distinction, the capital general ledgers will have to be differentiated into T1, T1E and T2. Only GLs marked as T1E should be used for computing this ratio. It must be noted that over period of time lesser and lesser items are permitted under T1.Thus based on the base data,

(A) = Tier 1 Equity Capital (GLs with flag T1E)

(B) = RWA as per Basel II computations =

Common Equity Tier I Ratio = (A) / (B)

4.3.1.2 Tier 1 capital (Common equity and Additional Tier 1) must be at 6% of RWA

Items eligible under Tier 1 of capital are listed under section 52-53,62of BIS guidelines

Items eligible under Additional Tier 1 Capital are listed under section 54-56,63-64 of guidelines

The General Ledger of the Bank would have GLs marked as capital for Basel II computation. They were not differentiated into T1 (Tier I), T1E (Tier I Equity) and T2 (Tier 2) separately as there was no separate ratio for T1 and T2 respectively. As Basel III requires this distinction, the capital general ledgers will have to be differentiated into T1, T1E and T2. Only GLs marked as T1E and T1 should be used for computing this ratio. It must be noted that over period of time lesser and lesser items are permitted under T1.Thus based on the base data,

(A) = Tier 1 Capital (GLs with flag T1E and T1)

(B) = RWA as per Basel II computations

Common Equity Tier I Ratio = (A) / (B)

4.3.1.3 Total capital (Tier 1 + Tier 2) must be at 8% of RWA

Items eligible under Tier 1 of capital are listed under section 52-53,62 of BIS guidelines

Items eligible under Additional Tier 1 Capital are listed under section 54-56,63-64 of guidelines

Items eligible under Tier 2 are listed under section 57-61,64

The General Ledger of the Bank would have GLs marked as capital for Basel II computation. They were not differentiated into T1 (Tier I), T1E (Tier I Equity) and T2 (Tier 2) separately as there was no separate ratio for T1 and T2 respectively. As Basel III requires this distinction, the capital general ledgers will have to be differentiated into T1, T1E and T2. Only GLs marked as T1E, T1 and T2 should be used for computing this ratio. Thus based on the base data,

(A) = Total Capital (GLs with flag T1E, T1 and T2)

(B) = RWA as per Basel II computations =

Common Equity Tier I Ratio = (A) / (B)

4.3.1.4 Disclosure (Reporting Requirements)

To improve transparency and market discipline, all banks must disclose full details of its core capital, additional Tier I capital, Tier II capital and regulatory adjustments applied on the same.

When reporting, the balances must be reported by General Ledger classifying it as Common Equity (T1E), Tier 1 (T1) and Tier 2(T2). The GL description will give details of the instruments which are classified as Capital. In order to have better clarity, there can be a link between the GL and clause number associated with the instrument (clause 52-64 of BIS accord). If the there are any regulatory adjustments applied on the balances of these GL, then the details of the adjustments must be described in the report.

4.3.1.5 Capital Conservation Buffer

Capital Conservation buffer is designed for banks to build capital buffers which can be used during periods of stress. A buffer of 2.5% is recommended for all rations described under 4.3.1.1 to 4.3.1.3.

When a bank enters the buffer zone, there will no restrictions on conduct of business but there will be restrictions on distribution of capital via dividends, bonus payments in cash and stock to employees. The restrictions on distribution of capital when a bank is operating in the zone of capital conservation buffer are given in table in section 131.

The minimum capital requirements for Equity Capital Ratio, Tier 1 Capital Ratio and Total Capital Ratio along with its conservation buffer are given in section 4.3.1 under End state ratios. The ratios computed in section 4.3.1, 4.3.2 and 4.3.3 will determine if the bank is undercapitalized, adequately capitalized but not enough buffer or adequately capitalized with buffer. The results can be depicted in the report by showing the ratios as green (adequately capitalized with buffers), amber (adequately capitalized without buffers) or red (inadequately capitalized).

4.3.1.6 Countercyclical Capital Buffer

Regulators will monitor credit trends in the country and may impose temporary capital buffer requirements on backs to curtail excessive credit growth and risk taking by banks.

The additional buffer could vary from 0-2.5% and may be withdrawn when the credit climate improves.

It could be applied at national level or at a bank level if it is observed that one bank is taking excessive risks

This is an additional buffer enforced on top of the buffer described in section 4.3.1.5. This is imposed when the market conditions turn bad and credit given in the market is not in line with growth. This additional buffer will thus prevent a run down under such adverse circumstances. When this is introduced by the regulator, we will have one more category for capital adequacy – Blue (adequately capitalized with buffers but not sufficient for countercyclical buffer). This will indicate that the bank is close to a risk of collapse and must tighten its release of credit especially to counterparties with poor ratings.

4.3.2 Global Liquidity Standard

Strong Capital requirements are a necessary but not sufficient condition for banking sector stability. A strong liquidity base reinforced by robust supervisory standards is essential as seen in the 2008 meltdown. To complement these principles, the accord was strengthened with two minimum requirements for funding liquidity. The two ratios are given below:

Summary of Basel III Liquidity Standards

- This is the first proposal of a global liquidity funding standard.
- Two primary liquidity risk measures proposed:

– **Liquidity Coverage Ratio (LCR)**

$$\frac{\text{Stock of High Quality Liquid Assets}}{\text{Net Cash Outflows over a 30 - day Period}} \geq 100\%$$

– **Net Stable Funding Ratio (NSFR)**

$$\frac{\text{Available Stable Funding}}{\text{Required Stable Funding}} \geq 100\%$$

4.3.2.1 Liquidity Coverage Ratio

The objective of this ratio is to ensure that bank maintains high quality liquid assets that can be converted into cash to meet its funding need over the next 30 days under a highly stressed scenario. The rationale for this ratio is that the bank management can take the required corrective actions in 30 days to ensure outflows are met through additional funding methods. While there may be some timing mismatches within the 30 days, the idea is that short term outflows must be met through a higher investment in liquid assets.

Stock of High Quality Liquid Assets

The stressed condition should address the following factors:

(a) Significant run-off of retail deposits

(b) Partial loss of unsecured wholesale funding capacity

(c) Partial loss of secured short-term financing

(d) Downgrade of bank by three notches and its related consequences

(e) Downgrade of collateral value due to market values above specified haircuts.

(f) Unscheduled draws on unused commitments that has been provided to customers

(g) Bank needing to buy back debt to mitigate reputation risk

Using the above stressed conditions an asset will be considered liquid if it meets the following characteristics:

Fundamental Characteristics

(a) Low credit and Market Risk

(b) Ease and certainty of valuation

(c) Low correlation with risky assets

(d) Listed on Developed and recognized exchange market

Market-related characteristics

(a) Active and sizeable market

(b) Presence of committed market makers

(c) Low market concentration

(d) Flight to Quality

Operational Requirements

The asset must be unencumbered. There must nothing constraining the sale of the asset to be converted to cash. It must not be linked to any exposure as a collateral or co-mingled with hedges which will not make it easy to liquidate the asset.

Based on the above characteristics and operational requirements, the list of assets qualified as high quality liquid assets even in stressed conditions are given in sections 34- 42. The liquid assets are classified into two levels – Level 1items (like cash) are not subject to any haircut while level 2 items are subject to haircut. There is no limit to the value of level 1 assets while level 2 assets (like assets in different currency) cannot constitute more than 40 percent of the high quality liquid assets pool after application of haircuts. A level 1 asset which is pledged as a collateral and maturing in the 30 day period will be treated as a level 2 asset.

Net Cash Outflows over a 30 day period

Net cash outflow in simplistic terms is defined as follows:

Total Net cash outflows over the next 30 calendar days = Outflows – Min (Inflows; 75 percent of outflows)

Thus 25 percent of outflows must be covered by high quality liquid assets as liquidity protection for the bank. Items that must be included in Outflows are defined in sections 51-104. Items included in cash inflow are defined in sections 105-118.

Since the computation is done under stressed scenario, the numbers from the General Ledger cannot be used directly. It can be used as indicative numbers but will have to be adjusted for stressed scenario. A simplistic approach could be the following:

Assets

- Tag Assets (HL and HLAV) as Highly Liquid Assets based on definitions as described above.
- Associate a stress factor to each asset based on stress analysis. This factor will indicate that only a percentage of the assets will be available in the 30 day period. This percentage will vary based on stress analysis scenario and results of the analysis
- The current value of the asset multiplied by the stress factor percentage will give you the funds that will be available in 30 days' time frame under stressed conditions

Liabilities

- Tag Liabilities as Highly Liquid Liabilities (30D, like Savings) based on definitions as described above.
- Associate a stress factor to each liability based on stress analysis. This factor will indicate a percentage in outflow during stress conditions the 30 day period – like a run on savings deposits. This percentage will vary based on stress analysis scenario and results of the analysis
- The current value of the liability multiplied by the stress factor percentage will give you the funds that will flow out in 30 days' time frame under stressed conditions

Inflows and Outflows

If a bank is making profits, its inflows will be higher than outflows. In this scenario, the net outflow has to be computed as 25 percent of outflows. The inflows and outflows will have to be computed under stressed scenario and hence the data from General Ledger will have to be adjusted and cannot be taken directly for computations.

Inflows

Inflows considered must be cash based and accruals and other non-cash based income should be excluded. This should be done based on flags on GLs to indicate if it is cash based income or not, Inflows will comprise of the following:

- Interest on placements – there could be delays in receipts in stressed scenario and this will have to be factored
- Dividends and interest on securities/bonds/equity – there could be significant reduction in dividends and interest receipts could be delayed. These will have to factored based on stress analysis.
- Fees from Fee based products
- Any other inflows like rents and other income

Outflows

- Run down on liabilities as described under liabilities section
- Operational Expenses for the next 30 days
- Additional interests on borrowings because of stressed conditions.

4.3.2.2 Net Stable Funding Ratio

This ratio is defined to measure the long term capability of a bank. It establishes the minimum acceptable amount of stable funding based on the liquidity characteristics of the institution's assets and activities over a one year horizon. It complements the LCR and ensures that banks balance their liquidity profiles over short term without ignoring medium to long term requirements. Stable funding is defined as equity and liability amounts from reliable sources over a one year horizon while the required funding is based on the liquidity characteristics of its assets including off-balance-sheet items. Items included under Available Stable Funding (ASF) are defined in sections 124-128 while items under required stable funding are Required Stable Funding are defined in sections 129-136.

This is the long term funding ratio where the bank makes an estimate of the funding required over a one year perspective versus funds available over a one year perspective. The funds required over a one year perspective can be estimated based on the following:

- Outflows that took place in the last 12 months
- Adjustments for business plans and changes in business scenario over the next 12 months
- Stress conditions likely to occur in the next 12 months leading to increased outflows.

The available funding over the next 12 months:

- All assets marked as highly liquid (HL) and periodic highly liquid (HLAV assets
- Increase in liquidity products due to business focus like Savings or term deposits.
- Any one off sale which will result in increased funds (mergers and acquisitions)

4.3.2.3 Monitoring Tools

The monitoring tools are to be used to supplement the two standards defined above. The purpose of these tools used by regulators is to measure the liquidity health of the bank. Though labelled as monitoring tools, they are as good as standards as banks will have to provide data to the regulators when they come to monitor the branch and it is advisable that they monitor these numbers internally on a periodic basis. Apart from the monitoring tools described below, there is work going on a monitoring tool for intra-day liquidity. The monitoring tools described here are the following:

- Contractual Maturity Mismatch
- Concentration of Funding
- Available Unencumbered Assets
- LCR by significant currency
- Market related Monitoring Tools

Contractual Maturity Mismatch

This metric helps identify gaps in funds flow based on mismatch of contract expiry dates within a specified period. This should include all on balance sheet and off balance sheet items. The objective is that over a period, the bank may appear very sound on liquidity but there could be intermediate gaps based on actual contractual maturity dates of assets and liabilities. This metric could be requested from overnight (daily) liquidity position to position of over 5 years based on the requirements of the regulators. The metric must be generated on the assumption that none of the liabilities will be rolled over and no new assets will come in place during the period of review. The contracts should include flows related to loans and deposits, securities flows and flows related to off balance sheet contracts. Collateral received from customers when used for liquidity must be monitored separately as it is not an unencumbered asset.

This metric does not consider any business strategic plans or growth into consideration and is just an as-is-where -is picture. The supervisor should look for funding gaps and the mitigation plans designed by the bank to overcome the gaps.

The LCR checks funding requirements over a 30 day period. However, it is possible that the funding requirements may clean over the 30 day period while there could be short term liquidity funding pressure because of liability items maturing early and asset items maturing later. This could lead to short term liquidity problems. In order to avoid, this scenario, most banks produce a Daily Sources and Uses report which tells the funding shortfall or surplus on a daily basis and not on a 30-day period. This will ensure that there are no intermittent problems within the 30 day period.

Concentration of Funding

There are three metrics computations which can be useful for monitoring this metric. They are defined below:

(a) Funding Liabilities sourced from each significant counterparty

The bank's balance sheet total

There is always a risk when the funding is over reliant on a single or a set of counterparties. It is recommended that funding from a single counterparty should not be a significant part of the total funding or liabilities of the bank. Bank should do a periodic check of listing all liabilities by counterparty and review where the liabilities from one customer exceed the prescribed limit of the total bank liabilities. Where it exceeds the prescribed limit, an additional risk factor must be added when evaluating funds from that counter party.

(b) Funding Liabilities sourced from each significant product / instrument

The bank's balance sheet total

Just like over reliance on customer, there can be problems if there is excessive dependence on one product for funding. What happens to funding if the product fails and is not able to generate adequate funding? It is recommended that funding from a single counterparty should not exceed a bank defined percentage limit of the total funding or liabilities of the bank. Bank should do a periodic check of listing all liabilities by product and review where the liabilities from one product exceed the pre-defined limits of the total bank liabilities. Where it exceeds the defined limit, an additional risk factor must be added when evaluating funds from that counter party.

(c) List of asset and Liability amounts by significant currency

The objective of this metrics is to ensure that funding is divided across many sources and not over dependent on one counterparty or product or currency. A counterparty of product is deemed to be significant if the funding of the item is more than 1% of the balance sheet amount. The currency is considered significant if the liabilities in the currency amount to more than 5% of the bank's liabilities. If (a) and (b) exceed 1% or if any exposure or liability in any currency exceeds 5% of the bank's liabilities, the bank must take corrective actions to decrease dependence on these sources for funding as there is a risk associated with it.

This is just a summary of all assets and liabilities by currency to see if there is very high exposure or reliability for funding on a specific foreign currency. If the risk of exposure or funding dependency is very high on a particular currency, management must take steps to neutralize the same and move exposures or funding from other currencies

Available Unencumbered Assets

The bank should be able to provide a list of available unencumbered assets that are marketable as collateral in secondary markets and/or eligible for central banks standing facilities. The metric basically gives an idea of the ability of the bank to raise funds on short notice in the secondary market. All assets must be listed with their associated market volatility haircuts to give an understanding of the cash that these assets will translate in short notice. It is recommended that the unencumbered assets are reported by significant currency (minimum 5% of total assets) to see liquidity requirements matching by currency of outflow.

This is a list of assets which have not been pledged as collateral and in other words it will translate to highly liquid assets. Even if an asset is liquid by its intrinsic features, it will become illiquid the moment it is pledged as collateral for some funding. Any asset which is not pledged as collateral and can be converted into cash in some definite time frame (not necessarily 30 days) will classify into this list. The idea is to measure the ability of the bank to generate funds, if required, at short notice.

LCR by significant Currency

While LCR is computed in a single currency to meet regulatory requirements, LCR by currency will give an indication of the bank's preparedness to meet obligations in each currency. It is defined as follows:

$$\text{FCY LCR} = \frac{\text{Stock of High Quality Liquid Assets in each significant currency}}{\text{Total net cash outflows over a 30 day time period in each significant currency}}$$

The principles are the same as computing LCR for the bank but it is done by currency. It is important to note that the outflows must be net of any foreign exchange hedges. Ideally, this ratio must be more than 100 percent but if it is less than 100 percent, it is fine if a bank has additional reserves in other currency which can be converted into the currency where there is a liquidity mismatch.

This ratio is the same as LCR described under section 4.3.2.1 with the exception that it is done on a currency by currency basis. This tells you of the bank's liquidity ability to meet funding needs without having to convert currency. If funding needs are met by the same currency, then the risk is lower for the bank. If conversions are to be done there is a haircut of 8 percent on the amounts to account for exchange fluctuations.

Market related monitoring tools

Supervisor must monitor market trends on an on-going basis and sport early warning signals based on market trends. There are three pieces of data which must be analysed regularly:

- Market wide information
  - Consider the market trends in equity market, debt market, foreign exchange and commodities
- Information on the financial sector
  - Validate that the financial sector market is moving along the same trends as the broader market place
- Bank Specific information
  - To review that market is not losing confidence in the institution and confirm if the trends are in line with other market players

The time table for implementation of Basel III liquidity metrics and ratios are given in the table under "Time table for Basel III changes in section 4.3.1

4.3.3 Leverage Ratio

One of the reasons for the recent economic crisis was excessive leveraging by banks of both its on and off balance sheet assets. The issue was exaggerated by a decreasing leverage due to declining capital base, and downward pressure on asset bases which led to huge losses. The leverage ratio must be a minimum of 3 percent for a bank and is defined as

Tier 1 Capital

Assets

The Tier 1 Capital as per new definition of Tier 1 capital which is primarily stocks issued by the bank and retained earnings after all regulatory adjustments.

Assets are all on balance sheet and off balance sheet items. There is no CCF applied to any off balance sheet item as this was the primary problem in the recent crisis. A CCF of 10 percent will be applied to unused commitments which unconditionally cancellable without giving any notice. The objective of this ration is to primarily constrain banks from leveraging without control. The items to be included in Tier 1 capital are defined in section 154-156 while the assets (exposure) are defined in sections 157-164.

The time table for the implementation of leverage ratio is given below:

- Trial period (Jan 1, 2011 to Jan 1, 2013)
- Parallel run (Jan 1, 2013 to Jan 1, 2015)
- Potential recalibration.
- Pillar 1 requirement: (starting Jan 1, 2018)

This is also shown in time table for implementation of Basel III in section 4.3.1.

The ratio is simple to compute – Numerator comprises of all items from Liability side flagged as T1 capital. The denominator is the total assets on the bank inclusive of on and off balance sheet items. If the percentage is higher than 3 percent, the bank is operating in a safe zone. If it is less than 3 percent, the bank is using other source of funds to leverage and build assets. While this is an acceptable form of business, doing it in excess can lead to a collapse of the bank if there is a demand for funds from where it was sourced. When one uses the common equity, it is the bank's own fund and there is no danger as it is its own funds. Excessive leveraging i.e. building assets using sources from other funds than the bank's own funds can be dangerous and should be avoided.

4.3.4 Risk Coverage

In addition to increasing the quality of capital and imposing liquidity and leverage metrics, there was a need to ensure that all exposures were covered with proper risk weights and nothing was missed out. The counterparty risk and some other areas were areas where the RWA computation process needed improvements. The areas are described below. The areas relating to counter party Credit Risk will come into effect from January 2013.

A. Counterparty Credit Risk

In addition to raising the quality of capital, it was essential that all exposures (on and off Balance Sheet) were captured and risk weighted correctly. This section addresses the changes in computations for counter party credit risk where there were some weaknesses. Counterparty Credit Risk (CCR) relates to the risk that an organization will not pay the due amounts on a future date due to liquidity issues or non-availability of funds or for any other reason. The reason for the change and the changes are summarized below:

Recognised Issue	Remediation
Procyclicality of the EPE measure.	Set the Basel 3 jump-to-default charge as the maximum arising from calculating EPE with current historical volatilities, and from calculating EPE with historical volatilities calculated across the same stressed period used to determine Stressed VaR under the market risk rules.
Potential illiquidity of large/complex/concentrated margined portfolios.	Increase the minimum period of risk from 10-days to 20 or 40-days, depending on characterisation of "large", or "complex". In particular, those cases where there is a history of large margin disputes with a client.
Interconnectedness of financial institutions.	Increase the AVC by 25% for: Regulated financial institutions, with assets > $50bn. All unregulated financial institutions.
Wrong-way risk	Set EAD to maximum remaining loss, conditioned on default, and LGD to 100%.
Capital was insufficient to buffer firms against p&l volatility arising from CVA/DVA.	Introduce an explicit "variability of CVA charge".
Subtleties	Increased PD for "highly leveraged counterparties". Re-securitisations no longer eligible as financial collateral. Implications for modelling finance positions in securitisations.

The exposure has to be computed as a deemed exposure as the exact value of the exposure (Expected Exposure) will not be the full value of the exposure but is normally computed as a sum of mark-to-market (MTM) and a notional value based on historical data (based on internal or external Credit Conversion Factor (CCF) or using Expected Potential Exposure (EPE)). The exposure could be negative if there are severe MTM losses – in that case the losses on replacement cost will be limited to zero. The changes in guidelines are addressed under five topics as given below and some items are applicable only for EPE method off computing only.

(a) Revised Metric to better address counter party risk, credit valuation adjustments and wrong way risk

There are three items covered this topic:

- Procyclicality of EPE measurement

One of the items not addressed under Basel II was the procyclicality of the EPE measure. In other words, the risk of counterparty default increases when the market conditions become worse. It has a direct linkage to market conditions. The guideline therefore specifies that the EPE computation must take the maximum of the following:

o RWA from EPE calculated with current historical covariance.

o RWA from EPE calculated with historical covariance aligned to the stressed period used to calibrate Stressed Value at Risk (VaR).

This will ensure that the RWA takes into account stressed market conditions or current conditions, whichever is worse and thus make it a conservative estimate.

The objective here is to compute a conservative RWA. If current conditions are worse than stressed conditions, then the market situation is very poor and hence we must use the RWA computed using current parameters. If however the stressed condition RWA is higher, then it will build safeguard against conditions becoming adverse in the market.

- Additional Credit Value Adjustment (CVA) Charge

While MTM was a factor in computing the total exposure for off-balance sheet future settlement instruments, the capital was insufficient to cover the profit and loss impact because of MTM variances. This charge is not required for transactions involving a central counterparty like an exchange and not required for SFT transactions unless the supervisor determines that the bank's losses from SFT credit value adjustments are material. This additional CVA risk capital charge is the standalone market risk charge calculated on the set of CVAs for all OTC counterparties. The CVA charge computation varies on the option chosen by the bank for computing counterparty risks (internal model or standardized) and are listed in sections 97-99. The following page gives a synopsis of the computations.

CVA Variability Charge

- Where an EE profile is available, determine the CR01 by tenor of the CVA expression:

$$CVA = (1-R)\sum_i 0.5 \times \left[EE_i z_i + EE_{i+1} z_{i+1}\right] \times PD_{i,i+1}$$

- Calculate 10-day 99% VaR and 10-day 99% Stressed VaR of these sensitivities, using offsetting sensitivities from single-name default swaps and 50% of credit indices in the CVA hedging book.
- Capital = multiplier x (10-day VaR + 10-day SVaR), where the multiplier is subject to regulatory approval, but is floored at 3.
- With permission, include CEM and ShortCut method exposures as a flat block extending to a maturity defined as the longer of half the longest maturity, or the notional weighted average maturity.
- For all other exposures use the EAD and effective maturity M to derive Standard Charges:

$$K = 2.33 \cdot \sqrt{h} \cdot \sqrt{\left(\sum_i 0.5 \cdot w_i \cdot \left(M_i \cdot EAD_i^{total} - M_i^{hedge} B_i\right) - \sum_{ind} w_{ind} \cdot M_{ind} \cdot B_{ind}\right)^2 + \sum_i 0.75 \cdot w_i^2 \cdot \left(M_i \cdot EAD_i^{total} - M_i^{hedge} B_i\right)^2}$$

- Charge is incremental to the Basel 2 charge, with the following modifications:
  - Current CVA can be subtracted from EAD.
  - For firms whose VaR captures the effect of rating transitions, the effective maturity M can be set to 1 for the purposes of the Basel 2 charge only, under Basel 3.

- Wrong Way Risk

Wrong way risk occurs when exposure by a bank to counterparty is adversely correlated with the credit quality of that counterparty. In other words, exposure is high to a counterparty whose creditworthiness is decreasing. Wrong way risk is classified into general and specific wrong way risk.

- General Wrong Way Risks (GWWR) relate to risks in the macro economic conditions and not specific to a counterparty. Like the current economic scenario of high interest rates and higher probability of default is general in the market. There are no specific capital charges for general wrong way risk.
- Specific Wrong Way Risks (SWWR) arises on specific transaction – e.g. they arise through poorly structured transactions, for example those collateralized by own or related party shares. For transactions with specific wrong way risk, Basel guidelines recommend the following treatment:

- Assign maximum remaining loss to EAD for credit default swaps with SWWR.
- Assign EAD for equity derivatives with SWWR commensurate with an assumption that the counterparty is in default.
- Apply 100% LGD.

In case of specific wrong way risk, the counterparty must be treated as a defaulted customer – EAD as exposure under standardized and 100 percent LGD for AIRB methods of calculation.

(b) Asset Correlation multiplier for large financial institutions

One of the factors that evolved out of the recent financial crisis was the interconnectedness of financial institutions leading a to a high correlation factor. This implied that if one did well, all did well or if one collapsed, it could trigger collapses all over. In order to address this risk the asset correlation factor in the IRB formula was increased by 25 percent leading to an increase in RWA of 33 percent. This will be applied to all customers – credit customers and counterparties. This increase will be applicable to Regulated Financial Institutions with total assets >$100bn, and for all unregulated financial institutions including hedge/ pension/mutual funds, (re)insurers and financial guarantors.

This is just a change in formula parameter for Financial Institutions Basel Asset Class under AIRB

(c) Collateralized Counterparties and margin period of risk

In order to address the risk associated with potential illiquidity with large complex/concentrated margin portfolios for derivatives and securities, the accord was revised to include the following clauses:

- Base supervisory floors on period of risk unchanged: 10-days for daily margined OTC, 5- days for daily-margined SFT. N+9 for N-margined OTC, N+4 for N-margined SFT.
- Requirement: Increase margin period of risk where:
  - There is a history of large, prolonged disputes with counterparty.
  - There is one or more complex or illiquid products in the portfolio.
  - There are more than 5,000 trades in the portfolio.
- For portfolios with > 5,000 trades, the supervisory floor for the period of risk is 20-days.
- Where one or more complex/illiquid products exist in the portfolio, a supervisory floor for the period or risk is 20-days.
- Where firms have had more than two “large” margin call disputes (to be calibrated) in the last two quarters that have lasted more than the applicable base period of risk, then banks must double the supervisory floor for that netting-set for the next two quarters.

This will address the liquidity issue with counterparties which were one of the critical factors in the recent financial crisis. Clause 106 gives guidelines for supervisory review (pillar II) in this area.

The Committee also recommends that the probability of default of highly leveraged companies should reflect the performance of their assets under stressed conditions.

The concept is simple – the more frequent margining is performed, the better it is as the exposure and collateral are marked to market and collateral is topped up, if required. If margining period is greater that one day, then there is higher risk of under collateralization. It is based on the principle that the longer the duration for which an exposure is held, the higher the risk of default. Hence the guideline proposes to increase the default duration in case the margining period is more than one day.

(d) Central Counterparties

This section has not yet been finalized by Basel Committee. They are waiting for the on-going work of the committee on payment and settlements (CPSS) and International Organization of Securities Commissions (IOSCO) to complete their work and will issue guidelines on this area after reviewing their recommendations.

(e) Enhanced counterparty Credit Requirements

This section (clauses 115-117) give guidelines relating to changes in stress testing specially as EPE computations require EPE to computed for every period with street testing for counterparty risk.

B. Addressing reliance on external credit ratings and minimizing cliff effects

This section relates to changes in guidelines relating to areas other than counterparty credit risk. It is described below in five sections as given in the guidelines.

(a) Standardized inferred rating for long term exposures

When a bank makes an investment in an instrument which is not rated, the current process was to either use the rating of the issuer or default it as unrated. The revised guidelines state the following:

- If the issuer has another instrument which is rated and can be proven to be similar in all aspects, then we can use the rating of the other instrument. If not, it should be unrated instrument.
- Issuer ratings are normally given for senior unsecured claims. If the investment in the in the instrument is a senior claim, then issuer ratings can be applied.

Under Basel II, if an issue specific rating was not available, so banks used to default to the issuer rating. Under Basel III, this will not be permitted. If Issue specific rating is not available, the rating can default to another instrument from the same issuer having similar characteristics but not to the issuer rating. If there is no other instrument with similar characteristics, then it will have to be treated as unrated.

(b) Incentive to avoid getting exposures rated

Banks should have a review mechanism to see if exposures to individuals or counterparty portfolios are reasonable. If the internal credit analysis review shows that the inherent risk is higher, then a higher risk weight must be applied. This will primarily applicable to areas where the exposure is unrated and the risks are deemed higher than the default assigned for unrated for that regulatory segment. The credit analysis department of a bank must analyse the rating from four angles:

- Risk Rating Systems
- Portfolio Analysis/aggregation
- Securitization/ Complex credit derivatives
- Large Exposures and Risk Concentrations

Under Basel II, one of the observations was that a majority of customers were unrated and given a default rating. However, the real rating could be worse than the default rating. Hence it is recommended that Banks must have a mechanism of rating customers and issues internally and check them with the ratings given by ECAIs. If the rating assessed by the bank is worse than the one given by the ECAI, then the internal rating must be used as a risk conservative measure.

(c) Incorporation of IOSCO's Code of Conduct Fundamentals for Credit Rating Agencies

This amendment is meant for regulators of a country and not the bank. The regulator must follow the International Organization of Securities Commissions (IOSCO) code of conduct. More specifically:

- The ECAI must publish publicly how the ratings were arrived, compensation received from the organization being rated, and details of issuer participation in the review, details of assessment, definition of default and the transition of ratings over time
- All assessment ratings must be available free of charge to banks

(d) Cliff Effects arising from guarantees and credit derivatives – credit risk meditation

- Credit protection given by Sovereign entities, PSE, Banks and Organizations with better rating will continue to be accepted
- All entities with lower risk ratings will qualify as guarantor except for securitization exposure
- For securitization exposure they must be currently BBB- or better and must have been A- or better when the protection was provided.

There is no implementation issue here. This is just an amendment to the definition of a guarantor. Under Basel II, it is pointless having a guarantor with lower rating as the rating of the obligor is taken into consideration when the rating of the guarantor is lower.

(e) Unsolicited Ratings and recognition of ECAIs

- In general, ECAI's must approve use of solicited ratings. A regulator may allow use of unsolicited ratings as long as the regulator is convinced that the unsolicited rating reflects a true picture of the credit rating of the company
- Regulators must not publish unsolicited ratings just to put pressure on organizations to get solicited ratings. The supervisors should keep a close eye on this aspect by monitoring the performance of the rated company and action must be initiated against the ECAI when such situations are observed

Solicited ratings are ratings done by ECAI on the request of companies and is thus done with full disclosure of financials. Hence it is fully reliable. Unsolicited ratings are ratings published by ECAI based on publicly available data and hence not fully reliable. Most regulators insist that only solicited ratings must be used. This clause says that ECAI must not publish unsolicited ratings just to get companies to get solicited ratings.

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