Association for
Financial Professionals

May 31, 2001

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System:
20th Street and Constitution Avenue, NW
Washington, D.C. 20551

Basel Committee Secretariat
Bank for International Settlements
CH-4002
Basel, Switzerland

Dear Ms. Johnson and Basel Committee Secretariat:

The Association for Financial Professionals (AFP) welcomes this opportunity to forward to you our comments on "*The New Basel Capital Accord*," the consultative paper issued by the Basel Committee on Bank Supervision of the Bank for International Settlements in January 2001. This paper was a follow up to the Committee's document "*A New Capital Adequacy Framework*" issued in June of 1999. We understand and appreciate that these papers present proposed approaches to revising the Basel Committee's 1988 Accord that developed a common capital adequacy framework for Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States.

AFP represents approximately 15,000 finance and treasury professionals who work closely with banks in arranging for credit and other financial services for more than 5000 organizations they represent. These organizations are generally drawn from the Fortune 1000 companies and the largest middle market companies. Many have extensive international operations and deal with both foreign and U.S. banks. We maintain information on the job responsibilities of our members. Although they encompass virtually all areas of financial management, over 3400 of our members indicate that their most important job responsibilities have to do with borrowing and bank relationship management.

Our original comment letter on "*A New Capital Adequacy Framework*," dated March 31, 2000, is enclosed with this letter. We believe all of the points raised in our earlier comment letter are applicable to "*The New Basel Capital Accord*."

The comments in this letter are only meant to amplify the issues discussed in our original letter and raise some additional points that are of interest to us as a result of the work done for *"The New Basel Capital Accord."* Accordingly, our comments will be confined to five areas: (1) Internal and external rating systems; (2) Determination of the overall level of capital; (3) Allowance for portfolio risk; (4) Allowance for collateral, guarantees and credit derivatives; and (5) Operational risk.

Internal and External Rating Systems

We are pleased that the Basel Committee has developed a sensible process for evaluating external credit assessment institutions (ECAIs) and determining whether banks can use their ratings for the purpose of determining their minimum capital levels. We endorse the six criteria that an ECAI must meet to satisfy a supervisor's assessment that its ratings may be used in determining minimum bank capital requirements:

1. Objectivity.
2. Independence.
3. Transparent international access to assessments and the methodology for determining them.
4. Disclosure of assessment methodologies and the things that would cause assessments to change.
5. Adequate resources.
6. Credibility.

While some ECAIs might not be currently capable of meeting such criteria, we believe they will ultimately strive to meet them. The use of external assessments as a means of determining risk weightings for bank capital requirements will create a new market for such assessments. We also believe that banks will want ultimately their customers to have such assessments because they serve to verify for their customers a core strength of the bank: its ability to adequately control and price lending risk. Stronger borrowers will require access to the assessments because good assessments provide the potential for more favorable loan terms.

We support the development of internal ratings systems as an important alternative to the external ratings systems approach. The existence of credible options for obtaining credit is most important for our members. As with external rating systems, we believe it is critical that internal ratings be applied consistently among all customers. AFP members' experiences have indicated that different banks may view the same customers differently, just as different external credit assessment institutions may view the same borrower differently. We believe that a critical component of the new Accord should be, that supervisory standards be imposed on both types of institutions to make sure that their standards are applied consistently across different borrowers with the same qualifications.

Financial systems in different countries have different degrees of transparency. This means that more information about potential borrowers is publicly available in some countries than in others. Where less useful information is available, banks will be taking on additional risk. It would seem appropriate to take this risk into account in setting capital requirements.

The Committee has done a good job in developing the criteria for both internal and external rating systems. If the usage of both approaches is consistently supervised by regulators over time, the Committee's work will have been an important contribution to the creation of a safer, more useful financial services system.

Determination of the Overall Level of Capital.

We are disappointed that the Committee has decided not to explain the rationale for the overall level of minimum capital from which risk adjustments are to be made. In an age when the financial services industry is undergoing rapid change worldwide, and when rapid technological change is having significant impacts on how risk is allocated within that industry and by its customers, this question is at least as important as the determination of risk adjustments for particular types of assets. We do not understand how the two questions can be separated.

We have three reasons for raising this concern. First, without knowing the rationale for determining the basic level of capital requirements, it is impossible for a borrower to discern whether some of the risk adjustments made through the use of ECAIs or the Internal Ratings approach have been replicated in the setting of the basic minimum capital requirement.

A more fundamental problem occurs because the banking industry does not exist in isolation. Banks compete with many institutions that will not be subject to this regulation. Technological change is breaking down barriers and making it easier for these non-bank institutions to compete with banks. We are concerned that if the level of minimum capital requirements is set too high because of concern about the need to preserve the safety and soundness of the banking system and the level of deposit insurance fund reserves, the actual results of this requirement may be counterproductive because business may flow out of banks and their profitability and viability would decline accordingly.

We urge the Committee to address the proper determination of the overall level of capital in its future deliberations and believe this should be one of the Committee's high priorities during and after implementation of the Accord.

Portfolio Risk

We are disappointed that the Committee was unable to allow banks to calculate their capital requirements on the basis of their own portfolio credit risk models. Such allowances would be useful to both banks and their customers. This approach could potentially provide an opportunity for a company with relatively high credit risk to obtain more favorable credit terms from a bank that had lower credit risks to offset it.

<u>Collateral, Guarantees and Credit Derivatives</u>

We support the use of allowances for collateral and guarantees. As mentioned in our previous letter, we believe the types of collateral that could be considered for risk mitigation allowances could be expanded beyond financial assets and gold. We remain optimistic that this approach will be considered in the future.

Credit derivatives are an important financial innovation that has enabled many borrowers to obtain low cost credit without the use of collateral or guarantees. Sometimes collateral is not available and guarantees are more difficult to obtain. Credit derivatives are generally standard contracts and are much more liquid than guarantees. We do not believe they are more risky than guarantees and urge the Committee reconsider its fifteen percent premium on capital charges for credit derivatives as opposed to credit guarantees.

<u>Operational Risk</u>

The Committee's approach to operational risk envisions three ways of determining capital charges for operational risk: (1) The Basic Indicator Approach; (2) The Standardized Approach; and (3) The Internal Measurement Approach.

The Basic Indicator Approach envisions the capital charge being a fixed percentage of gross income. The percentage would be determined from a survey of multinational banks taken by the Committee which indicated that the surveyed banks held twenty percent of their capital to protect against operational risk. This approach assumes that operational risk is the same at all banks regardless of their size, management capabilities or types of business.

The Standardized Approach envisions operational risk capital charges for different lines of business, with an indicator and capital factor for each line of business. "*The New Basel Capital Accord*" documents present an illustrative list of weighting factors based on the banks sampled by the Committee and some consultants' databases. The Committee's documents say both of these sources are biased.

Under the Internal Measurement Approach, risk types and exposure indicators are standardized by supervisors and individual banks are able to use internal loss data.

We are concerned that the Committee has not developed enough information to adequately assess the credibility of these approaches. Some of the sources of data are admittedly biased, and in our opinion, others are taken from a small sample of banks and do not include other variables that may affect operational risk – e.g., size of bank, quality of management, or creditworthiness of the customer. In addition, particular lines of business – e.g., payments mechanisms – may have significantly different operational risks depending on the country in which the business is being conducted. Clearly, the operational risks with a well regulated economy such as the USA are a fraction of the operational risk existent in an emerging economy or an economy that does not have a strong supervisory and regulatory oversight.

We recommend the Basel Committee not implement a system of capital charges for operational risk at this time. In our judgement the Committee needs to do more research on the factors influencing operational risk, and the sources of data about them. When this research is undertaken, the Committee should then release for comment a more detailed proposal with more fully justified methods of determining capital charges for operational risk.

Conclusion

The proposed "New Basel Capital Accord" offers several commendable improvements over the current system of bank capital regulation. Particularly important to our members is the system of risk based weightings for borrowers, provided it is consistently supervised. Better-rated companies should be able to obtain better pricing for their loans. Bank capital regulations will more accurately take account of the risks that are being assumed by banks. For these reasons we support implementation of most of the provisions of the new accord. We do not support implementation of the operating risk provisions of the new accord at this time. Additional work needs to be done on these provisions, as well as the provisions on collateral, guarantees and credit derivatives. We believe that most critical, in terms of the Committee's future agenda, is the development of a better rationale and methodology for determining the minimum overall level of capital. Without addressing this issue, the system of bank capital regulation will become increasingly less effective and gradually lose credibility.

Sincerely,

Patrick M. Montgomery
Vice President, Finance
ULLICO
Chair
AFP Government Relations Committee

Nolan L. North, CCM
Vice President and Assistant Treasurer
T. Rowe Price Associates, Inc.
Chair
Financial Markets Task Force
AFP Government Relations Committee