From: Alexey Simanovskiy, Bank of Russia, CPLG Member

To: Secretariat of Basel Committee on Banking Supervision

RE: Comments on the New Capital Accord

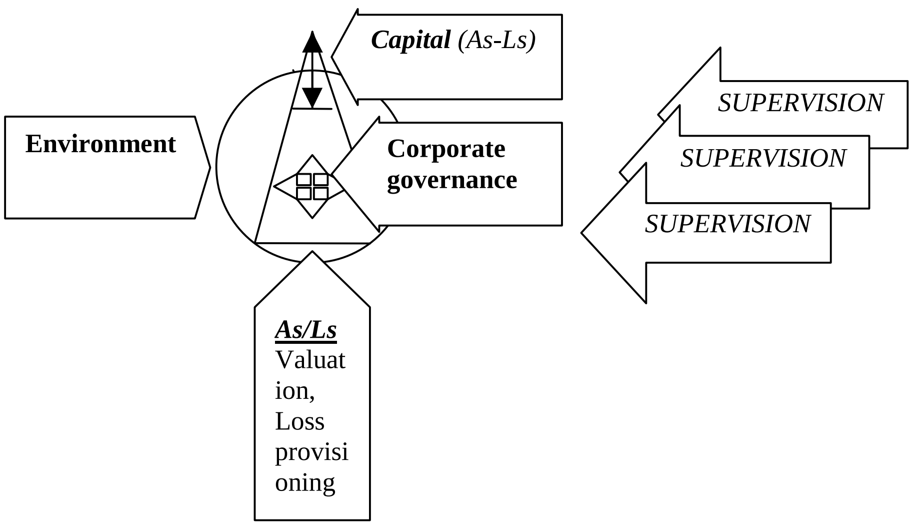
Dear colleagues,

Using the opportunity of commentary period I'd like share – now in writing - my views and my concerns on some issues of the New Basle Capital Accord (NCA).

1. The position of the capital adequacy regulation in the prudential regulatory system.

I believe that though capital adequacy is the very important element of any commercial entity soundness – and financial intermediary especially – nevertheless it is only an **element** in the **system**. Moreover, I believe that this element is not the "initial" or basic one. It is rather "derivative". Basic or initial elements of an entity soundness (or unsoundness) are time & value characteristics of its assets and liabilities. And time & value characteristics could be recognized like the result of environment (both broad market and non-market) and corporate governance influencing. On the practical side one of the most important matter is in the precise assets/liabilities valuing and fair reflection of this assessments in reporting. The problem of entity soundness and the role of capital adequacy in its ensuring could be illustrated by picture 1.1.:

Picture 1.1.



Picture 1.1. Entity's soundness, capital adequacy and supervisory targets.

The picture illustrates the statement that capital and its adequacy is only an element of more broad issue of an entity's soundness problem - and it is difficult to suppose any theoretical objection on this statement's fairness. So is there any necessity in stating it at all? I believe that yes. This believing is based on the feeling of the threaten of the gap emergence between theory and practice. Though CPs+MCP+Compendium (broad CPs) was designed and really has formed the methodology of the supervisory SYSTEM, the new capital proposals, especially pillars II and III, seem to be designed as competitors to CPs in the said area. There is a feeling that NCA pretends to be not only new (modern) but also comprehensive and hence most important word in the banking soundness (+ banking supervision) story. As a result banking and supervisory world have a (bad) chance to have at once **two-both-superior** supervisory methodical documents: CPs and NCA. It seems quiet probable now – and it would be unreasonable. The proper way is to avoid counterproductive dispute of two approaches. This way lays in the incorporation of new CA in broad CPs and specifically:

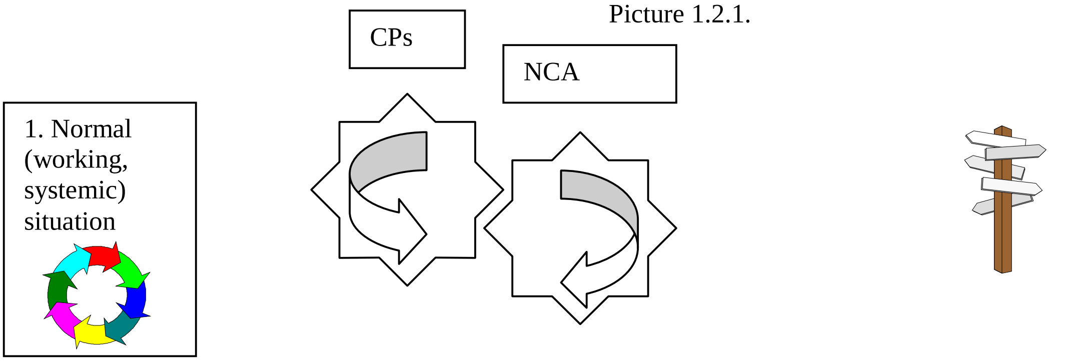
- full texts of all three Pillars are incorporated in the Compendium;
- MCP, best practice remarks in CPs and Principles themselves are properly amended (properly means here apart from everything else only by the necessity and with all possible caution).

In opposite case – sorry for repetition - it will be the sort of competition of two, both Basle-recommended, charters of the effective supervisory system. And the lack of certainty can harm the real process of the effective supervisory systems building. What is really needed for this building is clear architecture and **hierarchy** of approaches and methods. It presupposes the existence of the only major approach (method). This approach should contain the description of the hierarchy. The technical

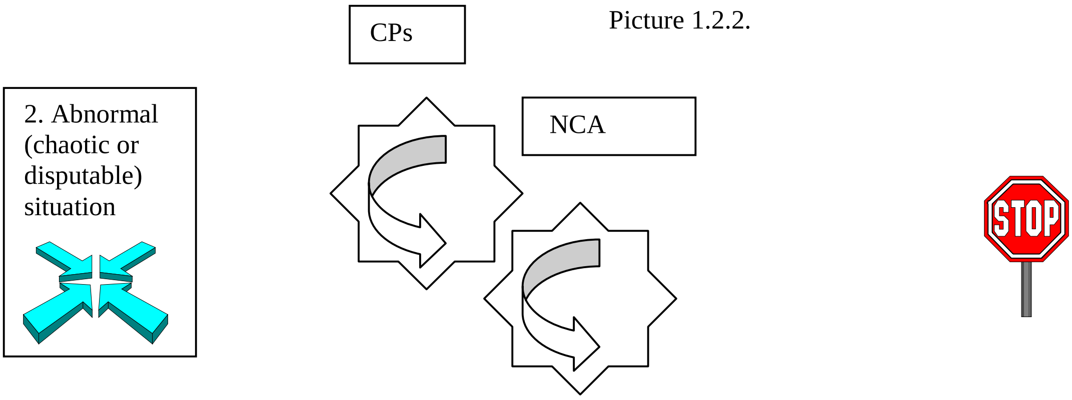
(detailed) subordinates could be supplemented to it. Obviously this approach is (has to be) **Core Principles**.

These concerns can be illustrated by the next pictures. Picture 1.2.1. illustrates the normal (working) situation, the result of systemic approach. Picture 1.2.2. illustrates the abnormal situation, the result of the existence of chaotic or disputable approaches.

Picture 1.2.1.

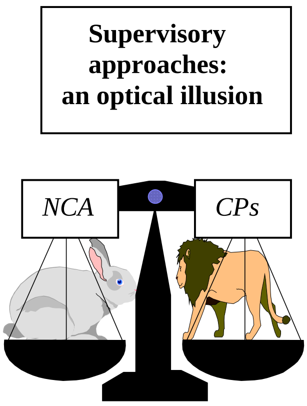


Picture 1.2.2.



Picture 1.2. The effect of coordinated (1.2.1.) and disputable (1.2.2.) organization of System.

Concluding this point it is worth to stress once again that imagination of comprehensiveness, universality and priority of capital adequacy issue is mistaken and misleading (Picture 1.3).

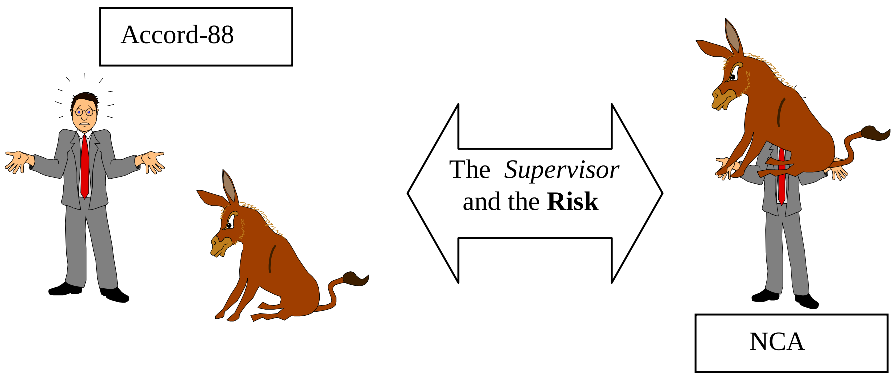


Picture 1.3. The comparable weight of supervisory methods.

2. The position of external risk assessors (ERA) and national supervisory authorities (NSA) in the risk assessment process.

NCA has proposed the dramatic changes in the system of credit risk assessment. Picture 2 illustrates them. The idea of involving ERA and **especially rating agencies** into the assessment process could be accepted in principle, but hardly in a straightforward way proposed by the consultation document. In any case supervisors have to be extremely cautious with its practical implementation. The ERA participation in risk assessment practice for being useful and at least not dangerous should develop only on step-by-step basis with different speed and scale in different countries – and with different final area of usage for supervisory purposes.

Instead of that NCA provides this never checked approach with enormous opportunities for the risk assessment. Moreover, according to the proposals supervisors have to play the role of outsiders (spectators), only blessing the real players (banks and ERA) to begin the game (see picture 2).



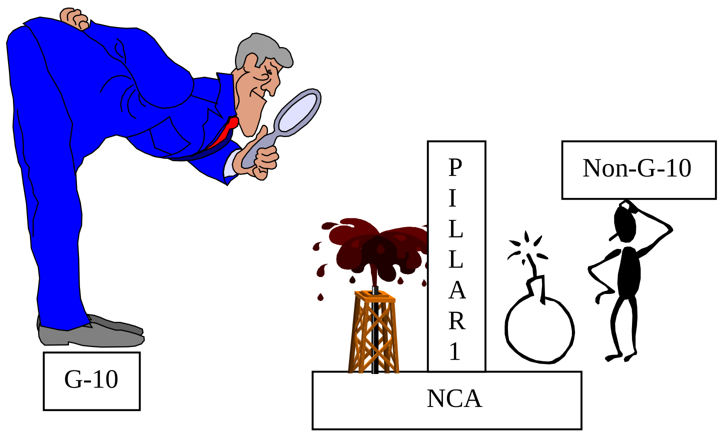
Picture 2. Capital accord, the Supervisor and the Risk.

But it is quiet not enough for supervisor to have only power to nominate players. Taking in mind that the scope of supervisor responsibilities will not be diminished under any system of risk assessment, the supervisor should have both "spectators'" rights and full-scale referee's power. Returning back from sport analogy to the prose of prudential supervision, supervisor should possess the power to take final decision on the risk assessment issues both in an individual case and on the systemic level. That is supervisor's assessment of the risk should have the superior power and so should not be limited by the matrix gauging risk ratios dependence from rating grades given by "independent" rating agencies. This point is gaining the importance with the transition from rough but stout risk assessment system to more "thin" – and shaky! - one. And the more risk assessment system is based on pure ERA's judgments – the more shaky it would be. **Most cautious and reasonable approach is in recognizing the rating by the kind of reference, more or less reliable depending on the case**.

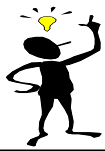
The practical regime of ratings' usage could be the next. Common **matrix'** recommended risk ratios should be recognized **floor** for the risk assessment purposes. **Supervisor** should possess the full opportunity to take any time depending on the environment and other relevant issues judgmental **corrective actions** with risk ratios both for individual institution/borrow and for whole matrix.

3. The psychology and dynamics of NCA implementation.

It has to be quiet clear recognized and declared that NCA implementation is not the duty, but rather



opportunity and even privilege for the country. So country in the common case has to properly check all the preconditions and possible results of NCAF implementation. And implement only those elements of NCA that will not hamper the situation with market discipline, banking system soundness and supervisory system efficiency. Revolutionary “improvement” of the capital adequacy requirements established in a country strictly according to most modern (but not proved) recommendations can in reality lead to the poor results especially in weaker, transitional economies with lack of market and legal preconditions for this cultural revolution. The proposals for the possible implementation of most important NCA approaches presented in the table bellow.


Approach	Economy	*Borrower*	
		Sovereign	*All others*
1	2	3	4
ER	*D*	*F – YES?!* *L – YES?*	*YES?!*
	T	*F -YES?!* *L- YES??*	*YES??*
IR	*D*	*YES??*	*YES?!*
	T	*YES??*	*YES??*

SYMBOLS:
ER – external rating
IR - internal rating
D - developed
T – transitional
F – foreign
L – local
YES? = possible with caution
YES?! = possible with limits/exceptions
YES?? = possible as an exception

As a result of this assessment it seems quiet obvious that practical regime of CA requirements in respective countries at least for the great majority of banking population should meaningfully differ from one proposed by NCA. So the “**simple**” CA methodology is strongly needed. And it is very doubtful that satisfactory decision could be founded out far beyond the frameworks of Accord-88. Hence the best choice is in the continuing of the old good Accord usage – certainly with all improvements reflecting the real findings of NCA (removing the club approach, reconsideration of risk mitigation techniques and some others).

4. Miscellaneous.
4.1. Procyclicality problem.
Not touching the macro aspect of NCA implementation it should be mentioned that so called *procyclicality problem* has supervisory issue. Indeed, because of higher flexibility of risk assessments under the new approaches (both ER and IR) the danger of risk underestimation during market upswings and its exaggeration during downturns increases. It is obviously unpleasant practical thing. Moreover, under certain conditions it could/should be recognized disappointing result for the whole ideology of new approach. Really, if we assess management and supervisory risk (M&S risk) through the measurement of deviation of estimated risk from real (existing) risk it is possible that more flexible and so more volatile credit risk assessments under proposed approach can lead to greater M&S risk than fixed ones under current approach.
The favorable for new approach meanings of M&S risks in two mentioned cases can be described by the next expression:

$$@ (Ra - Ri)^2 > @ (Rf - Ri)^2 ,$$

where Ri – real (intrinsic) risk weight,
Ra – estimated (assessed) risk weight according to NCA (ER or IR methods),
Rf – risk weight according to Accord-88 (fixed risk).

It is easy to prove that under certain conditions the left part of expression becomes less than right one i.e. result becomes unfavorable for new approach.

4.2. *More-than-100% risk*.

The proposed *More-than-100% risk* approach reflects the real problem of fair credit risks weighting for capital adequacy purposes and could be recognized technically suitable. In the same time it is methodically wrong. The expression “credit risk more than 100%” is literally irrational. This expression is equal in its sense to the expression “Pure cotton 150% T-shirt”. The point is that it is not possible to have content of the stuff in any thing more than 100%. Risk is the specific (“market made”) stuff of any deal. Because of it by nature risk in relative terms can not be more than 100%. But though it is impossible to increase content of any pie in relative terms (percents) it is quiet possible to increase pie in real terms or increase pies in quantity. For the case under consideration the proper decision could be

a) the CA requirement increasing - say, 1,5 times to 12% from 8% or
b) more strict provisioning requirement introduction: “150%” risk weight means 100% risk + creation of specific provision not less than 4% of loan value (4% = 50% of risk weight * 8% of CA).

Though this concern seems meaningless - the end justifies the means – practical consequences of this small technical innovation or rather its conceptual background (and to be more precise **the lack of any real conceptual background**) can be unpleasant. The matter is in the potential development of *ad hoc* approach to the prudential problems decision instead of systemic one. Because of increasing of problems in number and complication of them in quality non-systemic approach in basic points can lead to mess effect. This is, of cause, edge case, but even sign of movement in this direction should be avoided.

Sincerely yours,
Best regards

Alexey Simanovskiy
31.05.01