I. 362/011/01

Banco Central de la República Argentina
Presidente

Buenos Aires, May 30, 2001

Ms. Daniele Nouy
General Secretary
Basel Committee on Banking Supervision
Bank for International Settlements

Dear Ms. Nouy,

I am writing following your invitation to send comments on the second consultative package entitled "The New Basel Capital Accord". Since its release, our staff has been analyzing these new and much more detailed proposals. After a working session held with representatives of other Central Banks and Supervisors in the region, we have agreed on a consensus document in which we draw our conclusions and summarize our comments. I am then very pleased to be able to attach this new set of comments agreed by this group of Latin American countries. I hope this proves a useful exercise and will allow you to distill, more efficiently, the very large number of comments I am sure you will receive.

It is my sincere hope that these new comments will help the Committee to further improve the remarkable work already done. Moreover, I am sure that the outcome will contribute to a significant improvement to the 1988 Accord, which has already had a very important positive impact on the soundness of financial systems worldwide,including emerging economies.

Please feel at liberty to contact me or our staff for further clarification on any of the points or for future consultations if you consider them valuable.

I wish you every success in this important project. Yours sincerely,

Roque Maccarone

Attachment

The Proposed "New Capital Adequacy Framework"
Further Comments from a Group of Latin American Countries

Executive Summary

General comments. It is the opinion of the Group that:

- The new proposals are a significant improvement to the previous document. The IRB approach is an important step towards linking more closely capital to credit risk.
- Compliance with the New Capital Accord is achieved if it is applied to internationally active banks. The Group would like a clear statement in this respect.
- Some countries may still be moving towards full implementation by the dates established due to legal and technical difficulties and this will not mean lack of adherence.

Pillar I. It is the Group's opinion that:

- The Accord should allow that the IRB be used for a segment of the portfolio while the rest is treated under the standardized approach, subject to national supervisors approval.
- The Committee should urgently consider the issue of provisioning and should also continue to work actively and aggressively on an international agreement on this issue.
- The final document should include a very clear statement and extensive information regarding the calibration of both the standardized and the IRB approaches with respect to anticipated and non-anticipated losses.
- The capital requirement obtained as a result of both approaches (applied on gross financing) should be compared to the sum of provisions and capital and national supervisors should determine the extent to which these two instruments may be used.

The standardized approach. The Group thinks that:

- In the case of claims on banks, it is not clear that the floor at the level of the sovereign has been eliminated. The Group urges greater clarity on this issue. The minimum weight should be set at 20% with no relation to the weight for the sovereign.
- Regarding short-term claims, the Group suggests that a 20% weight should be maintained for financial lines of less than 6 months in jurisdictions where authorities have specific policies with respect to managing the liquidity risks of such lines.
- No distinction should be made as to the currency of denomination of the claims.
- Short-term trade related credit lines should keep a 20% risk weight.
- Regarding claims on sovereigns, the scale of weights is asymmetric and unnecessarily steep. There should be an intermediate weight of 75% for sovereigns rated BB+ to BB-.
- Reliance on a small number of external rating agencies will impose high pro-cyclicality.

The IRB approach. The Group believes that:

- Benchmark weights and other parameters may not reflect actual credit risks in emerging countries. The Group seeks greater definition regarding the methodology used to determine the relationship between probability of default and capital requirement.

- There should be more quantitative criteria regarding the performance of rating systems and backtesting techniques that assure that the rating systems are reliable not only in assigning rating grades but also in defining probabilities of default.
- Local supervisor should have the faculty to determine a different set of parameters, adjusted to local conditions, as long as they satisfy the criteria in the Basel regulation.
- Some local supervisors of this Group may like to develop a "standard IRB", using the theoretical framework of the IRB and adjusting the methodology to own data.
- There should be more detail on the methodology to be applied for sovereigns. This category of assets deserves a specific methodology and any extension of the methodology for corporates to be used on sovereigns may be inappropriate.

Operational risk. The Group understands that:

- The proposal has been calibrated to get an average total capital requirement equal to the current level for banks in the G10 countries, but the result may be very different when applied to non G-10 countries. The Committee should explicitly allow for other coefficients and indicators to be used in order to maintain the average level of capital.

Pillar II.

- The Group is concerned about the implementation of Pillar II, especially regarding legal protection for the supervisor. It may be very useful if the Committee could include some terms on the legal protection that supervisors should hold.
- It is the Group's opinion that the implementation of the principles can be achieved either by actual regulations or internal manuals of supervision, according to the legal environment.

Pillar III. The Group believes that:

- Any measure of risk published should consider the reduction of risk due to the use of credit risk mitigation techniques.
- The Committee should foster coordination with other regulators, in order to avoid regulatory arbitrage.
- Guidelines on exit rules and ways to control the pro-cyclical element of information will be highly valorized.
- There is lack of clarity as to how disclosure rules will be applied when there are differences between the rules established by the supervisor of a branch or subsidiary and those of the parent office.

Consolidation and related lending.

- The Group welcomes more comprehensive consolidation rules but observes that there are practical and legal problems to be solved on which the local authorities are working.
- The Group would like to see more detailed rules on consolidation. The equalization of accounting rules among regulators and among countries would be a worthy objective.
- The treatment of a subsidiary or branch where the parent is incorporated in another jurisdiction is an issue that is not clearly defined in the proposal.
- The Group would like to have a statement mentioning that, regarding investment in commercial entities, local supervisors may have the faculty to establish very strict limits and even forbid these investments.

The Proposed "New Capital Adequacy Framework"
Further Comments from a Group of Latin American Countries

Introduction

This is the second set of consensus comments from a group of Latin American countries to the Basel Committee on Banking Supervision (BCBS). We first briefly review the development of the current proposals and provide a summary of the previous set of comments from this group (section I). We then consider the new, much more detailed, proposals (and first analyze how the previous comments were taken into account by the BCBS (section II). We then present the comments on the new proposal limiting the remarks to where we have specific views (section III). The document is designed such that section III is self-standing for a reader who has good knowledge of the proposals and has read the previous comments of this Group.

In general, we believe that the new proposals are a significant improvement to the previous consultative document. In particular, the possibility of the use of banks' internal ratings is an important step towards linking more closely regulatory capital to credit risk, especially in environments where the universe of corporates with external ratings is limited and hence the standardized approach of less relevance (including many emerging countries). However, this Group also maintains its views with respect to certain issues where we feel the new proposals could be improved.

Section I.

1.1 The Current Accord

To ensure an adequate level of capital and a "level playing field" in the increasingly competitive international banking system, the Basel Committee on Banking Supervision introduced the 1988 Capital Accord. The main features included :

- a focus on the total amount of bank capital;
- the requirement that internationally active banks in the G10 countries hold capital equal to at least 8% of a basket of assets, weighted according to their risk;
- the classification of assets according to the debtor or debt category. Each category was assigned a different risk weight (0%, 20%, 50% or 100%). Almost all claims on the non-bank private sector were subject to a 100% risk weight;
- a scale of charges for off-balance sheet exposures;
- credit risk mitigation techniques were only partially recognized.

Market Risk Amendment

In 1996, a market risk amendment was published. This implied that trading positions in bonds, equities, foreign exchange and commodities were removed from the credit risk framework and given explicit capital charges related to the banks' open position in each instrument. This amendment has been the first step towards the use of banks' internal

models, since it has allowed banks to use their own systems to measure market risks, subject to quantitative and qualitative criteria and previous approval by the supervisors.

1.2 First Consultative Package on the New Accord – The June 1999 Proposal

Aiming at improving the 1988 Accord, the Basel Committee released in June 1999 a proposal to replace it with a more risk-sensitive framework. This Consultative Paper proposed some key modifications which, to some extent, reflect the *state of the arts* in risk management and the increased complexity of the banking industry. However, some topics remained opened to further discussion. The June 1999 proposal introduced:

- A structure of three pillars: Pillar I, minimum capital requirements, Pillar II, supervisory review process, and Pillar III, market discipline;
- incentives for better risk management;
- more risk sensitivity;
- a menu of approaches to determine capital requirements;
- incentives for banks to use their own internal methodologies to manage and measure credit risk, by contemplating the use of these methodologies subject to previous approval by the supervisory authority;
- guidelines to foster supervisory review and market discipline.

1.3 Comments from a Group of Latin American Countries

A group of Latin American countries (The Group) prepared and presented to the Basel Committee comments regarding this first Consultative Paper[1], focusing largely on the standardized approach to credit risk, which at the time was the most developed methodology in the proposal. The main comments were the following:

1. General comments:

- It is vital that any proposed modifications be considered in the light of how these could affect emerging economies as capital importers from banks in G10 countries or in non-G10 countries that wish to remain compliant with the Accord.
- The Group welcomes the efforts to improve the relationship between regulatory capital requirements and underlying economic risks, though believes that the analysis of capital requirements is incomplete without guidelines on provisioning rules.
- The Group welcomes the proposal to expand the scope of application of the new framework and the widening of the rules on consolidation. Nevertheless, a flexible approach should be adopted to take into account diverse legal and institutional structures.

2. Regarding the standardized approach of the first pillar:

- It is the Group's strong opinion that the Committee should recommend the use of banks' internal ratings for assessing sovereign risk. Private, external, credit-rating

[1] See appendix for the whole text of the consensus comments and for the list of countries that approved these remarks.

agencies have had, in general, a poor record in assessing sovereign risk. In fact, the Committee itself acknowledges that they are not completely reliable. The reliance on a very small number of external rating agencies could exacerbate pro-cyclicality. Indeed, private rating agencies have tended to follow market trends;

- The scale of weights proposed for sovereigns is asymmetric and includes abrupt changes, being unnecessarily steep. An improved table would have a symmetric pattern with more gradual changes between different weights;
- Changes in the risk weights for claims on sovereigns should be made gradually over a period of time, since a system of time-varying risk weights may lead to a pro-cyclicality that may induce systemic effects;
- Regarding banks, the Group prefers the second option in the proposal, but without a floor at the weight for the sovereign. More favorable rules for short-term claims on banks should be maintained if the national system of the obligor has sufficiently strict prudential rules. Lastly, a separate treatment should apply to domestic claims and to trade credit;
- For claims on banks (and corporates), there may be advantages in the use of external ratings depending on national characteristics. Accordingly, either internal or external ratings should be permitted at the discretion of national authorities;
- In the case of claims on domestic banks, national authorities should have the faculty to decide between an across-the-board 20% risk weight and a system of weights depending on the rating, in this case with a floor at 20%;
- For short-term claims on banks incorporated in countries with strict regulatory policies there should be a 20% risk weight or the weight of the same obligor's long-term claims;
- A distinction should be made between foreign trade credit and other credit lines. Since the former has performed well throughout recent periods of intense strain in several countries, the Group suggests that the 20% rule be maintained for them;
- The use of internal or external ratings (or a combination of both) for claims on corporates should be permitted, or ratings may follow a system set up by local supervisors, at the discretion of national authorities;
- The scale of weights for claims on corporates should be adjusted to give greater incentives for corporates to obtain a rating, reducing capital requirements more continuously as ratings improve and eliminating the sovereign floor;
- In the context of Latin American countries, the use of external ratings for corporate claims is likely to have only a limited effect, since the universe of rated corporations in these countries is small in relation to G10.

3. Regarding the objectives of the new framework

- The fourth objective, "focusing on internationally active banks", should not, in the Group's opinion, be an explicit objective at the same level as the first three, since many countries have adopted the present Accord as a baseline for their general minimum capital regulations.

Section II: The Second Consultative Package on the New Accord – The January 2001 Proposals.

These new proposals are much more detailed and specific than the previous consultative paper. They include:

1. *Overview of The New Basel Capital Accord.* This overview paper contains an executive summary and a description of the consultative package and of the changes with respect to the 1999 proposal;
2. *The New Basel Capital Accord.* It defines the content and structure of the New Accord, analyzing both the scope of application and the three pillars on which the proposal rests;
3. Supporting documents on specific topics providing technical analysis, descriptions of work in progress and guidance on implementation:
    a. *The Standardized Approach to Credit Risk*;
    b. *The Internal Ratings-Based Approach*;
    c. *Asset Securitization*;
    d. *Operational Risk*;
    e. *Pillar 2 (Supervisory Review Process)*;
    f. *Principles for the Management and Supervision of Interest Rate Risk*;
    g. *Pillar 3 (Market Discipline).*

All of the above have been issued for comment by 31 May 2001.

On the whole, the Group believes that these new proposals are a considerable advance on the previous consultative document. In particular the Group believes (a) that the new focus on the potential use of Internal Ratings is very positive, especially for jurisdictions where the universe of rated borrowers is small, (b) that the specific documents on asset securitization, operational risk, interest rate risk and pillars 2 and 3 are an important first step in attempting to quantify additional risks and in specifying further the role of the supervisor and the market in promoting appropriate monitoring and discipline.

However, the Group also believes that improvements could be made to the papers published. In the rest of this section it is first suggested that certain comments made on the first consultative paper should be incorporated into this new version. Second, additional comments are provided on the new material in this much more detailed set of proposals.

2.1 On the Response to The Group's comments in the second consultative package

In this sub-section, we first review some issues where we believe the BCBS has taken into account the previous comments made by this Group:

- Regarding the need for guidelines on provisioning rules, there is a mention in the new proposals: the document[2] declares that "The Committee is aware of the potential impact of provisioning practices on capital adequacy. In this regard, it is currently contemplating work on methods for addressing losses that are expected but have not yet materialized". We would urge the BCBS to urgently consider the

[2] Basel Committee on Banking Supervision, Consultative Document, "Overview of The New Basel Capital Accord", paragraph 44, page 9.

issue of provisioning, as explained in section III. The more quantitative the approach adopted for capital requirements, the more acute is the inconsistency given the lack of generally agreed rules on provisioning. We agree with the concept that provisioning should cover expected losses whereas capital the unanticipated losses subject to some statistical tolerance limit. We are therefore concerned that the new proposals appear to have calibrated risk weights to cover both anticipated and unanticipated losses.

- Regarding bank claims, there have been some modifications:
  - The floor to the risk weights at the level of the sovereign's weight appears to have been removed in option 2. The Overview[3] states that "The Committee is no longer seeking to establish a so-called sovereign floor but rather to allow for recognition of highly rated banks and corporates. Accordingly, exposures to banks and corporates that have external credit assessments higher than those assigned to the sovereign of incorporation may receive a preferential risk weight provided it is not less than 20%". However, it is not clear that the floor at the level of the sovereign has been eliminated, since the Consultative Paper[4], regarding the determination of risk weights in the context of the Standardized Approach, says that "When the national supervisor has chosen to apply the preferential treatment for claims on the sovereign,..., it can also assign, under both options 1 and 2, a risk weight that is one category less favorable than that assigned to claims on the sovereign of incorporation, subject to a floor of 20%, to bank claims of an original maturity of three (3) months or less denominated and funded in the domestic currency". The Group strongly suggests that the sovereign floor should be removed, and that the preferential treatment should imply a 20% risk weight, disregarding the sovereign risk weight, as explained in the next paragraphs. Moreover, the Group suggests that no distinction should be made as to the currency of denomination of the claims. In the view of the group such a distinction confuses the notion between credit risk and other risks.

  - Regarding short-term loans to financial institutions, the BCBS has now suggested a preferential treatment for loans of less than 3 months maturity. In our view this approach has a strong chance of being counter-productive. In other words it is likely to increase rather than decrease risk by ensuring credit lines are of shorter maturities and hence exacerbating liquidity risks. The Group suggests that the original 20% weight should be maintained for financial lines of less than 6 months in jurisdictions where authorities have specific policies with respect to managing the liquidity risks of such lines (explicit liquidity requirements, capital inflow taxes and the like).

  - The Group suggested in its previous comments that short-term trade related credit lines to financial institutions should keep a 20% risk weight. The Group maintains this position.

[3] Basel Committee on Banking Supervision, Consultative Document, "Overview of The New Basel Capital Accord", paragraph 74, page 14.
[4] Basel Committee on Banking Supervision, Consultative Document, "The New Basel Capital Accord", paragraph 33, page 10.

- Regarding corporate claims, there have been some modifications too:
  - It is proposed that the standard risk weight for unrated corporates is 100%, with a floor at the level of the sovereign. There is still an incentive to remain unrated, since this bucket carries a lower risk weight than those with BB- or less. However, this problem can be sorted out at the National Supervisor discretion, since the risk weight on unrated corporates can be raised, for example, to 200%, if the rate of default of corporates in the jurisdiction justifies it. The Group does not then think that this is an unreasonable position.

  - An intermediate 50% risk weight for A+/A- rated corporate claims is proposed, down from the 100% weight proposed in the 1999 consultative paper. The Group supports this change.

The Group also made specific comments regarding the risk weights for sovereigns in the standardised approach. While some changes have been made to the risk weights for corporates, those for sovereigns have not been changed. The Group maintains its view that the current proposals lack symmetry and risk provoking a systemic increase in the cost of capital if a country "falls off the cliff" from BBB- to BB+.

- **Sovereign (and central bank) risk weights using the Standardized Approach**

The new proposal specifies the following risk weights for sovereign and central bank claims[5]:

Table I.

Credit Assessment[6]	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk weights[7]	0%	20%	50%	100%	150%	100%

In the previous comments we suggested a symmetric scale, however, the scale of risk weights remained unchanged. There is also no mention of adjusting weights gradually should a change of weight occur. The Group would like to reiterate its view that the scale should be symmetric and that changes should be gradual to reduce problems of pro-cyclicality.

Although there is no reference to the problem of pro-cyclicality in the context of the standardized approach, the Committee's suggestion to solve this potential problem in the context of the IRB sheds light on what could be a general position "*...the Committee notes that the substantial risk sensitivity of the IRB approaches could imply changes over time in the capital required for particular assets as their quality varies over the course of an economic cycle. The Committee strongly believes that this implies the need for banks to address potential increases in regulatory requirements by performing stress testing and*

[5] They are the same as those proposed in the 1999 Consultative Paper.

[6] The consultative paper's notation uses *Standards & Poor's* methodology, though it could use those of some other external credit assessment agency.

[7] At national discretion, a lower risk weight may be applied to banks' exposures to the sovereign (or central bank) of incorporation denominated in domestic currency and funded in that currency. In this case, other national supervisory authorities may also permit their banks to apply the same risk weight to domestic currency exposures to this sovereign (or central bank) funded in that currency.

establishing additional capital cushions of their own during periods of economic growth. In the longer run, the Committee encourages banks to consider the merits of building such stress considerations directly into their internal ratings framework".

Section III Comments by the Group on the Second Consultative Package

The new proposals contain a much greater level of detail than the previous consultative document and new material is generally welcomed by the Group, especially regarding the Internal Ratings Based approach, and pillars 2 and 3. The Group understands that compliance with the New Capital Accord is achieved if it is applied to internationally active banks. We think that given the features of the new rules, implementation to the rest of the banks may be neither simple nor appropriate as it was the case of the 1988 Accord. The Group would like a clear statement as to what is the scope of banks that must implement the New Accord to achieve compliance. The Group has the following comments on these areas:

I. Pillar I. General comments

a) The Group urges the Committee to define the relationship between capital requirements and provisions more clearly. Of particular concern is a new paragraph in the second package (IRB approach) that states that "the Committee has therefore decided to publish corporate risk weights based on calibrating to assessments of EL (expected loss) plus UL (unexpected loss)"[8]. The Group also seeks greater clarity regarding the calibration of the risk weights in the standardized approach (are these designed to cover just unanticipated or unanticipated and anticipated losses ?).

The Group thinks that, from a theoretical point of view, provisions should cover expected losses and that capital should cover unanticipated losses, subject to some statistical tolerance limit. At the same time, the Group understands that there is no general agreement on provisioning rules and that in some countries provisions reflect ex post accounting losses or some other accounting concepts.

In the countries that constitute this Group, provisions tend to be much higher as a percentage of gross financing (around 8%), than compared to some G10 countries. In part this may reflect the fact that in some countries of this Group there is greater legal flexibility to adjust provisions than capital. The Group is then extremely concerned by the fact that the calibration of capital appears to have been made such that capital covers both expected and unexpected losses. This approach would, given legal inflexibility, be difficult to implement for many countries in the group, and given current levels of provisioning would lead to serious issues of double-counting.

The Group thinks that the Committee should publish the measure of expected losses embedded into the IRB approach and the standardized approach in order to be able to compare provisions with expected losses and capital with unexpected losses. The

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[8] Basel Committee on Banking Supervision, Consultative Document, "The Internal Ratings-Based Approach", paragraph 187, page 41.

Group thinks that the summation of provisions and capital should be considered to determine overall adequacy.

On a more general level, the Group believes that all efforts to implement a methodology such as the IRB, aiming at a more rigorous risk measurement, will be impaired if a satisfactory solution to the treatment of provisions is not found. Given this problem, the Group suggests. First, that there should be a very clear statement and full information regarding the calibration of both the standardised and the internal rating approaches with respect to anticipated and non-anticipated losses. Second, that there should be a clear statement in the main document explaining that the capital requirement that is obtained as a result of any of the approaches (applied on gross financing, i.e., before any netting of provisions has been made on any balance sheet items) should be compared to the sum of provisions and capital, and that it should be at the national supervisor's discretion to determine the extent to which these two instruments may be used. Third, the Group urges the BCBS to continue to work actively and aggressively on an international agreement on provisioning.

b) The Group would like to highlight that sovereign risk and corporate risk are of different nature. Given this view, the Group does not share the opinion of the Committee that there should be only one approach in place (Standardized or IRB) to apply to all the portfolios of a bank. As mentioned above, the Group thinks that in some cases the IRB approach may be superior to the standardized approach while this may not be the case for other segments of the portfolio. The Group recognizes the possibility of cherry picking but thinks that the potential benefits of being able to choose an internal rating approach for some portfolios while maintaining the standardized approach for others outweighs the potential for cherry picking. The Group suggests then that a bank should be free to choose the approach adopted for each broad portfolio.

II- Pillar I. Standardized Approach

a) The Group understands that offering loans in foreign currency in situations where there is a risk of devaluation or significant exchange rate risk may increase credit risk if this implies that borrowers have significant currency mismatches. However, in the view of the Group treating this as a different credit risk is not the appropriate route. The Group believes that credit risk and currency risk should be differentiated as much as possible and that in general, the currency in which the claims are denominated or funded should be independent of default risk. The possibility of allowing a preferential treatment for claims on sovereigns and short-term claims on banks, tied to the currency of denomination, is erroneous in the Group's view. The Group proposes that no distinction be made according to currency in order to apply these preferential treatments.

b) The Group is concerned that the reliance on a very small number of external rating agencies for sovereign risk will impose high pro-cyclicality to the capital ratio, especially considering that agencies' ratings have essentially followed market trends. The Group thinks that internal ratings for sovereigns may be more appropriate. On the one hand these ratings can incorporate relevant information from external rating agencies as one factor but may also incorporate particular information available to the

lending bank and the banks' opinion with regard to such subjective aspects as political risk.

c) The Group welcomes the Committee's efforts to increase the number of rating grantors, by proposing the use of Export Credit Agencies' (ECAs) assessments. However, the agencies are official organizations in some countries and could be influenced by decisions that follow other interests. The Committee seems to be attempting to control this problem by adopting OECD guidelines for ECAs to analyze sovereign risk. In this respect, we believe that sovereign risk is extremely difficult to standardize and that this approach may then lead to quite poor results in the attempt to link capital to actual risks. The Group looks forward to seeing greater degree of detail and specification regarding the potential use of ECAs' ratings.

d) The Group would like to see clear and transparent rules regarding the use of external rating agencies For example if a domestic bank has a claim on a foreign debtor, the proposal does not appear to specify whether the approval of the rating agency is the responsibility of the domestic regulator, the regulator of the foreign country or either. The Group suggests that there should be a passport system such that if a rating agency is deemed to be qualified by one regulator of a country that has applied the Accord, then that agency is qualified for any jurisdiction that has applied the Accord.

e) As was pointed out in the first set of comments, the scale of weights proposed for sovereigns is asymmetric and includes abrupt changes, being unnecessarily steep. The Group would like to see an improved table with an intermediate weight of 75% for sovereigns rated BB+ to BB-. This would mean a more symmetric pattern with more gradual changes between different weights.

f) Regarding the preferential treatment for short-term claims on banks, the Group would like to have a clear statement in the final document as to whether this treatment is available also for foreign banks lending to domestic banks. The Standardized Approach Supporting Document says that this specific rule has been introduced to maintain liquidity in domestic interbank markets, so we find it is not clear if the treatment should be restricted to domestic banks lending to domestic counterparts.

g) The Group would like to insist that short-term trade related credit lines keep a 20% capital charge. These lines have performed well throughout recent periods of intense strain in several countries and therefore do not justify a sharp increase in their weights.

h) The floor for claims on banks should be set at 20% with no relation to the floors for weights given the weight of the sovereign.

i) The Group welcomes the more comprehensive rules on credit risk mitigation and credit derivatives.

j) The Group is concerned that unsolicited ratings be used and would like to see more defined rules in the final document.

III-Pillar I.IRB

a) As was already expressed, the Group thinks that the Committee should allow that the IRB be used for a segment of the portfolio while the rest is treated under the standardized approach.

b) The Group looks forward to seeing more detail on the methodology to be applied for sovereigns. The Group thinks that this category of assets deserves a specific methodology and that any extension of the methodology for corporates to be used on sovereigns may be inappropriate as the risks involved are of a different nature and require separate calibration.

c) The benchmark weights and other parameters developed for the IRB approach may not reflect the actual credit risks in emerging countries. The Group then seeks greater definition regarding the methodology used to determine the relationship between probability of default and the capital requirement. The Group thinks that local supervisors in emerging countries may seek to develop their own differentiated parameters, adapted to domestic systems, and in compliance with the qualitative and quantitative standards of the Committee. In this regard, the Group thinks these standards are not sufficiently developed in the proposal and that more detail regarding the underlying methodologies is required.

d) Methods for backtesting rating systems are not yet well developed nor are there sufficient criteria in the documents to validate the models used to assign rating grades. We would like to get more quantitative criteria regarding the performance of the models. Furthermore, the passage from a set of rating grades to probabilities of default and vice versa is not trivial. There should be well defined standards to assure that the systems are reliable not only in assigning rating grades but also in defining probabilities of default.

e) Therefore, for the members of the Group, it seems to be convenient that the supervisor has the faculty to determine a set of different levels of parameters, adjusted to local conditions, as long as they satisfy the criteria in the Basel regulation. We would like to see a statement in this regard in the final document, even if the different levels are subject to a minimum at the levels proposed by the Committee.

f) In many of the countries of this Group there are well-developed public and/or private credit bureau policies. The Group would like to inform the Committee that some local supervisors may like to develop a "standard IRB", using the theoretical framework of the IRB and adjusting the methodology to the data available in a particular jurisdiction. Under this approach, a supervisor may then provide banks with the methodology or the calculated parameters (including PD) to be used.

g) If the supervisors were to provide the rating system or the methodology to assign the probabilities of default, some problems may be overcome: (i) the comparison of different national capital ratios would be much simpler; (ii) there would be less disadvantages for banks starting-up new operations, as they would be able to apply the supervisor's methodology, while they would otherwise be precluded from using the IRB approach since they would not count with the data; (iii) some statistical problems would be overcome due to the reduced size of the data sample for some banks; (iv)

there would be economies of specialization; (v) at first some banks may not have the expertise/knowledge required to implement the IRB on their own.

IV-Operational Risk

a) The Group understands that the current proposal on operational risk has been calibrated in order to get an average total capital requirement equal to the current level of capital for the banks in G10 countries. It is most probable that the parameters obtained will lead to very different results when applied to other countries. Therefore, the Group suggests that the Committee should explicitly allow for other coefficients to be used in non-G10 countries, as local supervisors may also wish to maintain the average level of capital. Local supervisors should develop their own assessments of operational risk in their systems and, consequently, should have flexibility as to the level of capital required to cover this risk and the most appropriate indicators to be used. The Group suggests that the Committee attempt to delineate the types of issues that national supervisors may wish to take into account in those assessments and the range of operational risk that might result.

b) The Group believes that the current proposals on operational risk fall between two stools. On the one hand, the basic indicator approach imposes a high impact capital charge (20% of current capital requirements) but with a very rough measurement. On the other hand, the standardized and internal measurement approaches require a causal relationship between risk indicators and loss estimates. Many banks have not developed internal loss data, and external databases have to be "calibrated" to the specific bank and country. More study is needed to get some estimation of operational risk in the systems of the countries member of the Group.

V- Pillar II

We agree with the improvement of the supervisory process as proposed by the Committee. However, we are concerned about the implementation of the principles in Pillar II as they are dependent on (i) the legal framework, (ii) technical abilities and (iii) legal protection for the supervisor.

The Group will work to overcome these difficulties. In this respect, we think that it may be very useful if the Committee should include in the final document some terms on the legal protection that supervisors should hold.

The BCBS should make clear how this pillar is to be implemented in practice in order to achieve compliance with the Committee's rules. There are different interpretations about the implementation of Pillar II. For example, in some countries the IMF and other organizations appear to be looking for actual regulations on these issues (in the context of ROSCs and FSAPs) whereas other parties understand that Pillar II means precisely not regulations but that such issues should be included in internal manuals of supervision. Naturally, given different legal faculties granted to supervisors, these may need different instruments to achieve compliance. In countries where there is supervisory discretion over capital requirements then the principles of Pillar 2 may still be reflected in capital or other requirements even if the rules are not directly stated in the regulations per se. In other countries the supervisors may need an explicit regulation in order to be able to apply the principles in Pillar 2. Therefore, the Group would like an explicit statement in the final

document establishing that the implementation of the principles can be achieved by the two different vias explained, according to the legal environment.

VI- Pillar III

The Group supports the move towards greater bank disclosure. The Group would like to highlight that disclosure rules should attempt to give meaningful measures of risk. The Group agrees that disclosure rules should be mindful of truly reflecting exposures and risk and therefore any measure published should consider the reduction of risk as contemplated in the treatment of credit risk mitigation techniques.

It is important that the Committee foster the coordination with other regulators such as IOSCO in order to have similar disclosure rules.

The Group is also concerned about the pro-cyclical element of information. Guidelines on exit rules and ways to control this negative effect will be highly valorized.

The Group also suggests that the BCBS give its opinion on the development of institutional methods for the market to process banks' information. Specifically, the Group would like to have the Committee's opinion on two techniques, the use of external credit rating agencies and the use of a rule that obliges banks to issue periodically some small quantity of subordinated debt in the market.

Where a bank has a branch or a subsidiary in a foreign country there may be differences in disclosure rules as established by different supervisors. We would like to see how these differences are to be solved as well as what level of consolidation should the host country supervisor oblige to disclose. In this respect, differences between accountancy standards may impose a difficult obstacle.

VII-Consolidation Rules and Related Lending

The Group agrees with the introduction of more comprehensive consolidation rules but is aware that the implementation may be a gradual process especially in countries where consolidation rules are not in place yet. We would like to make the Committee aware that there are practical and legal problems to be solved on which the local authorities are working.

We would like to see more detailed rules on consolidation, especially regarding the accountability of different supervisors according to the location of the different layers of a banking group.

We would like more precision on upward consolidation. In this respect, the equalization of accounting rules among different regulators and among countries would be a worthy objective. The treatment of a subsidiary or branch where the parent is incorporated in another jurisdiction is an issue that is not clearly defined in the proposal, in the Group's view. This point affects the three pillars and may be very significant, so we look forward to specific rules in this regard.

Regarding related lending, the Group welcomes the existence of limits on non-banking investments. However, in some countries members of the Group, local supervisors have set

much stricter limits than those in the Committee's proposals, as a result of local experience. We would like to have a statement in the Accord mentioning that local supervisors have the faculty to establish very strict limits and even forbid investments in commercial entities.

VIII- Timing

The Group is concerned that legal and technical difficulties may prevent the members from achieving a full implementation of the proposals by the dates established. We are also aware that an uneven introduction of new methodologies could provoke some deterioration in competitive equality. Therefore we would like to advance that some countries may still be moving towards full implementation by the dates established and that we understand that this will not mean lack of adherence of observance of the New Capital Accord.

Appendix I.

The Proposed, " New Capital Adequacy Framework"
Comments from a Group of Latin American Countries

Introduction

The Basle Committee on Banking Supervision recently published a proposal to modify the 1988 Capital Accord. The Committee has invited comments from interested parties by the end of March 2000 on the consultative paper entitled, "A New Capital Adequacy Framework" (henceforth the Paper). Although the 1988 Accord formally established minimum levels of capital for internationally active banks in G10 countries, it has been adopted as a standard by over 100 countries and has also been applied to a much wider range of institutions. Consequently, any modification of the Accord could have profound effects. First, for emerging countries -that in aggregate are significant capital importers- modifications could change the cost of capital and produce significant effects on financial sector development and on economic growth. Hence the Group believes that where requirements are increased this should be clearly justified in terms of a higher level of risks. Second, countries that have made it an objective to apply the Accord locally will have to adapt local regulations to ensure continued compliance with potentially significant cost for regulators and domestic financial institutions. It is therefore vital that any proposed modifications are considered in the light of how this will affect emerging economies as recipients of G10 bank financing and their relevance to the many countries that wish to remain compliant with the Accord. The following comments represent the consensus-remarks of an ad hoc group of Latin American countries (henceforth the Group) and have been agreed by their various country representatives (Central Bank or Superintendency) – see Annex 1 for a detailed list.

The members of the Group welcome the Committee's efforts to improve the relationship between regulatory capital requirements and underlying economic risks. At the same time the Group believes that the analysis of capital requirements is incomplete without guidelines on provisioning rules. The Group believes that provisions should reflect expected losses while capital should reflect potential unexpected losses and urges the Committee to develop further guidelines on provisioning requirements according to this view. The Group broadly welcomes the proposal to expand the scope of application of the new framework and the widening of the rules on consolidation. At the same time the Group suggests a flexible approach to take into account differing legal and institutional structures, which imply that some countries might encounter problems in implementing this change in full.

The following comments are intended as a set of constructive remarks, which the Group hopes will allow the Committee to improve on the Proposal in the coming months.

1. The First Pillar: Minimum Capital Requirements

(i) The Group believes that the assessment of sovereign risk is fundamentally distinct from the assessment of other types of obligor risk. Furthermore, the Group considers bank's internal ratings as appropriate for assessing sovereign risk rather than those of external

rating agencies. For bank and corporate claims the Group believes external ratings may play a valuable role –explained further below.

1.1 The evaluation of sovereign risk is very different from the evaluation of risk of a corporate or a bank. It is therefore likely that different methodologies may be appropriate for different types of risk. The Paper considers first the standardized approach and subsequently an internal ratings approach. In the main body of the paper, the use of external ratings is discussed within the context of the standardized approach. However, the Group believes that internal ratings could be employed alongside a standardized approach (that is, banks may "map" internal ratings to the standard risk weights as discussed on page 37 in the Annex of the Paper). The Group's view is that such an approach would be appropriate for the evaluation of sovereign risk and indeed has several advantages over the use of external ratings. In the context of bank or corporate claims the Group does see potential advantages for the use of external ratings as discussed below.

a. Claims on sovereigns

(ii) The Group's strong opinion is that the Committee should recommend the use of internal ratings in the case of sovereign claims.

1.2 The Group's view is that private, external, credit-rating agencies have, in general, a poor record in assessing sovereign risk. Nevertheless, a vital part of the proposed new Accord would rely on these assessments, even though the Committee itself acknowledges that they are not reliable (Annex 2, paragraph 5, page 27). Furthermore, the reliance on a very small number of external rating agencies could exacerbate pro-cyclicality. Indeed, private rating agencies have tended to follow market trends. A negative market trend leading to a ratings downgrade and hence to an across the board increase in capital requirements may then lead to a further deterioration in market access creating an unstable and potentially self-fulfilling vicious circle. Moreover, other external assessment institutions do not clearly outperform rating agencies, with the added obstacle that their ratings may not be public. While the Group recognizes that internal ratings may also provoke pro-cyclical effects (see 1.5 below), the Group suggests that internal ratings should have a greater role (Consultative Paper, paragraphs 25, page 13). The Group suggests that, given the limited spectrum of major banks lending to a set of emerging market borrowers, appropriate standards and cross-controls for internal ratings could be developed, perhaps by the BIS. The Group urges the Committee to give urgent consideration to these issues.

(iii) The Group disagrees with the scale of weights proposed for sovereigns presented in the paper (Table 1) which the Group notes is asymmetric and includes abrupt changes. The Group suggests that an improved table would have a symmetric pattern with more gradual changes between different weights.

1.3 Notwithstanding the above comments on external ratings, the Group suggests that the proposed schedule of risk weights (Table 1, page 31) to be applied to claims on sovereigns is unnecessarily steep and asymmetric. There seems to be no justification for such an asymmetric schedule included in the Paper. The Group proposes that

smoother transitions between categories be applied and that the scale should be symmetric.

(iv) The Group proposes that changes in the risk on claims on sovereigns be made gradually over a period of time.

1.4 The change from a system of constant risk weights to time-varying risk weights may lead to pro-cyclicality (as discussed in 1.2). This is particularly the case for claims on sovereigns where such pro-cyclicality may also induce systemic effects. When the obligor is a sovereign, the Group then proposes that changes in weights be brought in gradually over a period of time.

b. Claims on banks

(v) The Group suggests that risk weights for claims on banks should depend on their ratings (second option), but without a minimum floor at the weight for the sovereign, and the Group suggests that more favourable rules for short-term claims on banks be maintained if the national system of the obligor has sufficiently strict prudential rules. In addition, a separate treatment should apply to domestic claims and to trade credit.

1.5 The Proposal contemplates two approaches for claims on banks (Annex 2, paragraphs 10-13, pages 28-29). The Group does not agree with the first option as the Group believes that linking bank risk to sovereign risk is inappropriate given that these risks are very different in nature.

1.6 For claims on banks, the Group shares the criterion embedded in option 2 regarding the use of risk weights according to the obligor's rating, but the Group thinks there should not be a floor for the weights at the level of that of the sovereign. Indeed, some rating agencies have rated bank claims (and claims of corporates) higher than claims of their respective central government and hence it is not clear why, on the one hand, the Committee is suggesting that rating agencies add value in terms of credit analysis but on the other hand the Proposal includes an arbitrary restriction of a floor at the level corresponding to that of the sovereign. The Group urges that in the individual ratings approach the floor be eliminated.

1.7 For claims on banks (and corporates - discussed further below), the Group believes there may be advantages in the use of external ratings depending on national characteristics. Accordingly, the Group proposes that either internal or external ratings should be permitted at the discretion of national authorities.

1.8 In the case of claims on domestic banks, the Group suggests that national authorities should have the faculty to decide between an across-the-board 20% risk weight and a system of weights depending on the rating, in this case with a floor at 20%.

1.9 Under the Proposal, capital charges on short-term claims on banks would jump from 20% to the sovereign floor, which, for many members of the Group, implies a weight of 100%. This abrupt change represents a very significant cost for many countries and in a number of cases current requirements cover the risk inherent in these claims. Indeed, the authorities of many emerging countries have made very significant strides to improve the soundness of their financial systems (e.g. by adopting the 1988

Accord, often with stricter limits, and implementing the 25 Core Principles for Effective Banking Supervision). In the Group's view, capital requirements for claims on banks should not be unrelated to the quality of local regulations. Otherwise, the current proposal may be counterproductive in that the increased cost of higher capital charges may simply increase the cost of maintaining conservative prudential regulations and put pressure on the regulators to relax those prudential guidelines. Therefore, the Group suggests that the rule for risk weights on short-term international claims on banks should factor in domestic regulations. Specifically, the Group suggests that for short-term claims on banks incorporated in countries with 'strict regulatory policies' a 20% risk weight or the weight of the same obligor's long-term claims. The definition of 'strict' here should be related to the adoption of the 1988 Accord or the results of assessments on the Basle Core Principles for Effective Supervision. The assessments being conducted by the IMF and the World Bank or assessments by private agencies could be employed in this regard.

1.10 Furthermore, the Group suggests a distinction between foreign trade credit and other credit lines. In particular there is evidence that trade credits have performed well throughout recent periods of intense strain in several countries and there is little reason to change the current rule for short-term claims of this type. The Group therefore suggests that the 20% rule be maintained for trade credit lines.

c. Claims on corporates

(vi) The Group suggests that, similar to the treatment for claims on banks, the use of internal or external ratings should be permitted, or that ratings may follow a system set up by local supervisors, at the discretion of national authorities. The Group also suggests that the scale of weights be adjusted to give greater incentives for corporates to obtain a rating and that the sovereign floor be eliminated.

1.11 As discussed above, the Group believes that the use of external credit ratings to determine regulatory capital for corporates may have notable advantages as compared with the current regime. However, in the context of the countries that are members of this Group it is likely to have only a limited effect. Currently, most rated corporations are those that trade actively in the stock market or have issued bonds or other instruments locally or abroad but the universe of rated corporations in the member countries of this Group is small in relation to G10. Moreover, the most serious problems of credit risk assessment derive from the non-rated sector. As the current proposal stands (see Annex 2, paragraphs 18-19, page 30), there would be improvements in the credit risk assessment of loans of higher credit quality but little improvement to credit risk assessment of banks' overall portfolios. To bring better incentives to corporations to get a rating, the Group suggests that the proposal should introduce a more progressive scale. In the proposed schedule, a credit rating downgrade for a corporation from AA- to A+ would lead to a five-fold increase in the capital requirement at the same time that there is a clear incentive for not obtaining a rating for any corporation that might potentially get a rating below B-. The Group suggests the consideration of a finer scale that gives greater incentives for corporates to obtain a rating and reduces capital requirements more continuously as ratings improve. The Group also proposes to eliminate the floor to the risk weight at the level of the weight corresponding to the sovereign.

1.12 The Group believes that the use of banks' internal ratings for corporates should also be permitted. However, in some cases this could tilt the playing field to the detriment of institutions with less analytic capabilities. For this reason, the Group believes that national authorities should decide the type of rating that will be admitted: external, internal or a combination of both. Additionally, the Group thinks that the application of rating systems for corporates set up by the national supervisors should be acceptable, and they should decide the way these systems would be applied. Several members of this Group already have such systems in place and are used to analyze corporate credit risk.

2. *Objectives of the new framework*

2.1 The three initial objectives of (1) "promoting safety and soundness in the financial system", (2) "enhancing competitive equality" and (3) "constituting a more comprehensive approach to addressing risks" are all quite clear and unquestionable. However, the fourth objective, "focusing on internationally active banks" should not, in the Group's opinion, be an explicit objective at the same level as the first three. Taking into account that many countries have adopted the present Accord as a baseline for their general minimum capital regulations, the fourth objective appears unnecessary or, at least, insufficiently precise, even with the qualification that "its underlying principles should be suitable for application to banks of varying levels of complexity and sophistication". The Group's view is that there appears little justification today to maintain this as an explicit objective of the new framework.

2.2 The Group strongly supports the addition of the two new Pillars (Supervisory Review Process and Market Discipline) to the key pillar of capital adequacy that was first set out in the 1988 Accord. The Group believes that in the future greater attention should be placed on these supporting Pillars and urges the Committee to further develop the proposals included. In doing this, the Committee should bear in mind that the time for implementing any actual proposals should consider the costs of modifications, implicit demands on supervisors and also the possible legal restrictions in different countries.

2.3 The Group supports the proposal to develop explicit capital charges for "interest rate risk in the banking book" and "other risks" insofar as these may be quantified.

ANNEX 1

LIST OF COUNTRIES AND RELEVANT AUTHORITIES THAT HAVE APPROVED THE ATTACHED COMMENTS

ARGENTINA
Banco Central de la República Argentina

BOLIVIA
Superintendencia de Bancos y Entidades Financieras

COLOMBIA

Banco de la República

COSTA RICA

Superintendencia de Entidades Financieras

HONDURAS

Comisión Nacional de Bancos y Seguros

PARAGUAY

Banco Central del Paraguay

REPUBLICA DOMINICANA

Banco Central de la República Dominicana

URUGUAY

Banco Central del Uruguay, Superintendencia de Instituciones de Intermediación Financiera

VENEZUELA

Banco Central de Venezuela