Banco de Mexico's comments on the Basel Committee´s second consultative package entitled "The New Basel Capital Accord"

Claims on sovereigns under the standardized approach

The immediate impact of the proposed changes to the ratings on foreign currency sovereign debt will be higher risk weights for OECD sovereigns with ratings lower than AA. We reiterate our recommendation that those higher weights should apply only on new claims and not to the existing ones, or suggest as an alternative, a period of gradual transition.

Scope of application: Investments in non-financial companies

The Second Consultative Package on the New Accord incorporates a new section called "Scope of Application" which includes issues on consolidation and situations of double or multiple gearing concerning banks' investment in commercial entities. These issues, which were not covered in the First Consultative Package, are important to establish a leveled playing field among international credit institutions.

Concerning banks' investments in commercial entities, the Accord's Proposal establishes that if individual "significant investments" in commercial entities exceed 15% of the banks' capital, the excess has to be deducted from Tier 1 capital. For aggregate "significant investments" the excess above 60% of the banks' capital has to be deducted.

A bank's capital should be available on an on-going basis to support risks in its balance sheet. Excessive gearing can limit this objective. The proposed materiality levels seem too generous if compared with regulation in many countries, for example, the U.S., Chile, and Mexico. Experience has shown that banks' investments in commercial entities can have several implications, such as undesired extensions of the safety nets, conflicts of interest, transfers of risk to banks, and transfers of profits from banks.

The Accord could be more explicit on what is meant by "significant investments". It seems that it partially adopts the regulation now in place in the European Community. In this, "significant investments" are defined as those where direct or indirect investments exceed 10% of the issuing firm's equity or voting rights, or when there is a possibility of exerting significant influence in the firm's management.

Guidelines on Provisioning Rules

The Second Consultative Package does not set guidelines on provisioning rules. In agreement with comments by other institutions, it is considered that the proposal cannot be effective without basic international agreement on standards for loan classification and provisioning, as capital and capital adequacy depend on accurate valuation of bank's assets. Capital should protect against unexpected losses while expected losses are to be covered by specific loan loss provisions. Under-provisioning of assets renders capital adequacy measures inaccurate.

Minimum Capital Requirements

We believe that policy should be developed concerning other assets to be deducted from a bank's capital, such as capital instruments, related party lending, deferred tax assets, goodwill and other intangible assets and illegal operations.

Claims on sovereigns, banks and corporations.

Although the proposal incorporates new credit risk buckets (50% and 150%), the scale of weights remains asymmetric and unnecessarily steep. In order to smooth the impact of the transition between buckets, more intermediate risk categories should be included.

Standardized vs. IRB approach

Banks should have the flexibility to apply either the standardized or the IRB approach to different segments of the portfolio. The Accord should allow for the IRB to be used for a segment of the portfolio while the rest is treated under the standardized approach, subject to national supervisors' approval.

IRB on sovereign claims

Given that sovereign risk and corporate risk are of different nature, individual banks' assessment of sovereign risk under the IRB approach may be difficult and subject to possible conflicts of interest. Therefore, we suggest that only the standardized approach should be applied on sovereign claims.

Risk weights of claims secured by residential property

We strongly support the use of credit risk mitigation techniques (collateral and third party guaranties) in the general framework. However, we encourage the Committee to reconsider the low risk weights assigned to mortgage loans, and include them instead as loans subject to risk mitigation.

Operational risk

The 20% capital weight applied under the standardized approach seems to be too high. However, a fine-tuning is expected after the on-going consultation with the industry. This topic should be left open for further discussion until the results of the consultations are published.