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31 May 2001

Madame Daniele Nuoy
Secretary General
Basel Committee on Banking Supervision
Bank of International Settlements
CH-4002 Basel
Switzerland

Dear Ms Nuoy,

The New Basel Capital Accord Consultative Paper 2001

We refer to the matter above and would like to congratulate the Bank of International Settlements (BIS) on the issuance of the Second Consultative document on the New Basle Capital Accord in January 2001.

2. We are pleased to note that the new accord is in the final stages of completion towards replacing the existing capital adequacy framework in order to be more risk sensitive and to give greater recognition on the risk management capabilities of the individual banking institutions. While the framework is directly applicable to internationally active banks, we believe that, once it comes into effect, it will become the new standards on banks' capital adequacy globally. Therefore, we are of the view that the New Accord should adequately take into account the opinion of not only internationally active banks in developed markets, but also banks operating in emerging markets like Malaysia. Greater flexibility should be accorded to supervisors, particularly in emerging markets in implementing the various options given in the accord given its wide implication to the banking sector. Furthermore, it is imperative for the implementation of the Basel recommendations to be consistent with the developments in the respective markets and the extent to which the system is able to adapt to the new requirements. In particular, the potential impact of the framework during periods of economic crisis or downturn would need to be adequately assessed to ensure the framework does not precipitate greater instability to the financial system.

3. We also understand Mr David Carse of the Hong Kong Monetary Authority has expressed the views of the EMEAP Working Group on Banking Supervision. In addition to this, we attach herewith other comments on the new accord incorporating

feedback we have received from the banking institutions in Malaysia. We sincerely hope that these comments will be useful for the committee in finalising the new framework and look forward to any future developments in this area.

Warmest regards.

Yours sincerely,

(Nor Shamsiah Yunus)
Director
Bank Regulation Department

<u>Attachment</u>

New Capital Accord - Second Consultative Paper
Comments by Bank Negara Malaysia

Issue 1: The emphasis on ratings by External Credit Assessment Institutions

The reliance on external rating in determining capital charges proposed under the new accord could result in a substantial increase in demand for additional capital during periods of economic downturn and high non-performing loans as under this environment, risk downgrades could be prevalent.

It should also be emphasised that during periods of economic slow down or financial crisis, it is important that the bank intermediation process in not disrupted. However, with corporate downgrades becoming more likely and the difficulty to find borrowers with good credit standing, banking institutions would be discouraged from extending new loans as their capital buffer would be eroded due to the deterioration in asset quality.

Given the disadvantages of reliance on the external rating, an alternative would be to work towards implementing the internal rating based approach for compliance with Pillar I. Nevertheless, this would take more time in the case of emerging markets where data availability and system constraints could be serious problems *(Please refer to Item 8)*.

Issue 2: Eligible collateral

Under the new accord, credit risk mitigation <u>excludes any form of property</u> from the list of eligible collateral for mitigation purposes. Given the regional environment where loans granted are often collateralised by property, banks would be penalised by higher capital charges unnecessarily. Similarly, many borrowers especially small and medium sized enterprises would find it difficult to secure loans at reasonable rates if banks are not willing to accept property as collaterals.

Moving forward, it is felt that property collateral should be allowed for credit risk mitigation purposes, perhaps, subject to applying the appropriate haircut. It is also suggested that the following items be included in the list of eligible collateral:

(a) Corporate Guarantees of sovereigns with ratings of BBB- and above;
(b) Bank Guarantees of banks with ratings of BBB- and above; and
(c) Listed hybrid equities (ie. ICULS) as they have similar characteristics to listed equity.

Item 3: Off Balance Sheet Items

The new accord states that a credit conversion factor of 20% is to be set for off-balance sheet commitments that have a maturity of less than 1 year with the exception of commitments that can be unconditionally cancelled or can be cancelled without due notice in cases of a drop in borrower credit worthiness.

In practice, borrowers would be very concerned if lenders could cancel their loans <u>without due notice</u>.

The definition of the exception should be changed to cater for short-term commitments that can be <u>cancelled on demand</u> or <u>within a short notice period</u>. A more specific suggestion is a 1 month or 2 week grace period.

Similarly, as the new accord allows for on balance sheet netting, it is proposed that off-balance sheet netting should also be included, for example transactions involving foreign currency and derivatives. This is to be done by allowing the pre-settlement netting of positive mark-to-market exposure against negative mark-to-market exposure with the same counterparty.

Item 4: Short-term interbank transactions

Under the new accord, the maturity tenure for short-term interbank transactions is proposed to be shortened to 3 months from 1 year. While, these short-term interbank transactions are rewarded under the new accord by receiving a risk-weight that is 1 level lower than received from the external ratings assessment, the move from 12 months to 3 months tenor could result in greater volatility in the interbank market. The maturity criteria for these transactions should be be brought to 6 months as proposed in the 1st Consultative Paper rather than the proposed 3 months.

Item 5: Operational Risk

Under the new accord, operational risks attributed to an institution are accorded a flat capital charge of 20% based on their gross income. The flat charge of 20% is not reflective of the actual operational risk and should also not be only relative of gross income.

The calculation of operational risk should instead be based on the standardized approach. However, the financial indicators, business line weights and structure should be calibrated against regional norms rather than those stated by the BIS, which tend to be more reflective of developed countries. Qualitative factors should also have a greater part to play in the calculation rather than just quantitative indicators. Banking institutions that are more efficient and have better risk management systems should also be duly rewarded rather than penalized based on their gross income.

A lower capital charge should also be provided for well-managed banks with appropriate internal risk mechanisms. This will in turn encourage banks to have better internal risk systems and to capture internal loss data.

In the local environment, a flat charge between 5 to 10% would be more reflective of the operational risks face by banking institutions. Furthermore, insurance taken by banking institutions against losses on operational risks should be recognised in the operational risks mitigation process.

A simpler but similar method to the Internal Measurement Approach, which provides a more reflective correlation to the operational risk of banking institutions should also be explored in determining capital charges for operational risks

Item 6: Lending to sovereigns

Under the current capital adequacy framework, local currency lending to the sovereign is risk free whilst foreign currency lending is provided a 100% weighting.

The new accord sets the risk-weight based on sovereign ratings, thus lending to the local government would dependent on the rating given to Malaysia. However, experience indicates that the government is able to raise considerable foreign currency funds from locally incorporated foreign banks at better rates than those available in the global market. This is generally due to these banks being in the country and recognizing better the risks attached to these exposures and having better understanding of the sovereign risk profile. However, under the new accord these transactions would carry higher risk-weight thus incurring higher capital charges, resulting in higher funding cost to governments, especially those in emerging countries.

Item 7: Loans to corporations

The new accord provides a 100% risk-weight for corporations rated between BBB+ and BB-. This weighing should differentiate between investment grade (BBB and above) and non-investment grade corporations (not assigned the same rating). Hence, corporations rated BBB and above should be rated more favourably e.g. at 50% risk weight.

Item 8: The Internal Ratings Based

Under the foundation approach, certain commercial and residential real estate are eligible as collateral. However, the LGD of 40% where the ratio of collateral value over the nominal value exceeds a second higher threshold level of 140% seems high.

In deriving the LGD, there should also be more differentiation between the situation where eligible collateral is less than 30%(LGD is 50%) and eligible collateral is more than 140% (LGD is 40%). Real estate in any form should be able to be used as eligible collateral as long as it fulfils the criteria specified in paragraph 316 to 321 of the new accord. Subsequently, appropriate haircuts should be applied for the different types of collateral. Supervisory agencies should be given the flexibility to determine the effective LGD which better reflect the conditions of specific markets.

It is also thought that the definition of default under the IRB should not include restructuring if a loss has not been incurred due to the restructuring, as this would discourage banking institutions from restructuring loans as a pre-emptive measure to avoid loan defaults.

Item 9: Segregation between SMI and retail customers

Under the IRB, the definition of corporate exposures are debt obligations of a partnership, corporations or proprietorships including SMEs, multi-nationals and small business which all obtain the source of repayment through on-going operations rather than through projects or property.

On the other hand, the definition of retail exposures vary in different regions, but generally concern low value, high volume consumer lending. The concern is that the accord does allow for small businesses to fall under either category
A clear line has to be set to distinguish between these two types of customers as the new accord could allow for small businesses to come under either category.

Loan size should also not be the only determining factor on segregating between categories. Besides loan size, turnover and asset size should also be used in determining whether a borrower comes under the SMI category or the retail customer category.