Comments on New Basel Capital Accord
Consultative Document issued January 2001

1. Scope of Application

Views Shared by the Regulator and Banking Industry

(1) In the wake of the Asian financial crisis which began in 1997, banks in Asia have undertaken a large volume of debt restructurings. Many of the debt restructurings, have taken the form of debt- for-equity swaps, resulting in large holding of equity on the balance sheets of Asian banks. Those investments, which in a number of cases exceed certain materiality levels, are required by the New Basel Capital Accord (Accord) to be deducted from the bank's capital, thereby exacerbating already reduced levels of capital. Since the equity positions acquired in debt-for-equity exchanges are not intended to be long-term equity investments, but rather to rehabilitate the business operations, treating them as ordinary investments and applying risk weights – as opposed to deducting the investment from capital – is more appropriate.

Views of the Banking Industry

(2) The Accord strongly recommends the full deduction of investments in insurance subsidiaries. For significant minority-owned equity investments in non-insurance financial entities the investment must either be deducted from the bank's capital or pro rata consolidation may be applied. These requirements will have a severe impact on the financial condition of banks. Frequently in cases where a bank holds between 20% and 50% of the equity in a non-insurance financial entity, pro rata consolidation is not possible because of a lack of financial data. As a consequence, banks are forced to adopt the deduction method. It would seem that applying risk weighting methodology to investments in insurance companies and significant minority-owned equity investments in non-insurance financial entities will help mitigate the impact while at the same time sufficiently covering the risks inherent in the investment.

(3) National supervisors are permitted to choose among several options when determining the appropriate method to monitor a bank's capital adequacy (for example, option 1 and 2 for claims on banks). If supervisors exercise their discretion in different ways, banks that have operations in several countries will be required to adopt different approaches to calculate required capital. Moreover, they may be faced with multiple layers of supervisory reporting requirements. The Basel Committee is requested to provide guidance regarding the application of differing capital methodologies and multiple layers of supervisory reporting requirements (as specified by home and host supervisors) for supervisors that oversee banking groups operating in more than one country.

2. Standardised Approach

2.1 Preferential Risk Weight Disclosure

Views Shared by the Regulator and Banking Industry

(1) National supervisors are permitted to apply preferential risk weights for claims on sovereigns, which are denominated and funded in the local currency. This type of discretion, exercised by each national supervisor individually, may not be applied or based upon similar standards. Encouraging each supervisor to disclose sovereigns – on a country by country basis – preferential risk weights permitted for claims on other will help to mitigate this problem.

2.2 Some Treatments Will Create Disincentives for Banks to Mitigate Their Risks

Views Shared by the Regulator and Banking Industry

(1) In a tranched credit guarantee structure, even though the senior tranche is guaranteed by the protection provider, the junior tranche (1st loss portion), if retained by the bank, will be deducted from the bank's capital. Although there is a cap that the total capital requirement will not exceed that on an otherwise identical loan on which there is no credit protection, the benefit from capital reduction may be so low that banks have no incentive to acquire credit protection.

(2) The Accord does not recognize for credit mitigation purposes, hedges with a residual maturity of less than one-year where the underlying exposure has a maturity of greater than one year. As a consequence, banks will not be motivated to hedge their risks since they will receive no capital reduction benefit. This also penalizes and creates disadvantage for banks in countries where hedges with a residual maturity of over 1-year are not available.

(3) Since only financial collateral is recognized for credit risk mitigation in the standardized approach, a transaction collateralized by non-financial collateral will receive the same risk weight as a similar transaction without collateral. This will place unsecured transactions and those transactions secured by non-financial collateral on equal footing from a risk perspective, which is clearly not the case. In many countries where financial markets are not as fully developed, traditional bank lending is most commonly secured with physical collateral. Not allowing banks that operate in these countries to recognize physical collateral for credit risk mitigation purposes will put them at a competitively disadvantaged position. To resolve the issue, physical collateral should be recognized for credit risk mitigation purpose with an appropriate haircut applied to reflect its liquidity and price volatility.

Views of the Banking Industry

(4) Equal treatment for short-term and long-term claims – with the exception of claims on banks under option 2 – does not truly reflect the different level of risks in short- and long-term claims. The Accord's treatment of maturity will encourage banks to grant more long-term loans relative to short-term loans, due to their higher returns but equal capital costs.

2.3 Inappropriate risk weight for unsecured portion (net of specific provision) of assets, which are past due for more than 90 days.

Views Shared by the Regulator and Banking Industry

(1) The portion of a credit that is covered by physical collateral should be recognized as secured for the same reasons as stated in 2.2(3)

In principle, a risk weight of 150% should be applied only to assets deemed irrecoverable, defined in many countries as assets which are past due over 1 year. The Basel Committee should recognize this fact and change the characteristic of assets for which a 150% risk weight is applied from assets past due more than 90 days to those that are past due 1-year or more.

The risk weight for claims secured by residential real estate rises sharply from 50% to 150% (2 risk categories) once the credit becomes past due. Risk weights should increase step-by-step i.e. from 50% to 100%, making the appropriate risk weight for past due residential mortgage claims 100%, not 150% as is recommended in the Accord.

2.4 Limitations Arising from a Limited Number of External Credit Rating Agencies

Views Shared by the Regulator and Banking Industry

(1) Problems may arise from an insufficient number of External Credit Rating Agencies available to provide credit assessments for the entire system.

(2) Recognized International Credit Rating Agencies may not fully understand the local situation and market practice of the countries and companies that they are rating.

2.5 Issues That Need Further Clarification from the Basel Committee

Views Shared by the Regulator and Banking Industry

(1) The assumptions and a description of the methodology used to derive the supervisory haircuts and the credit risk mitigation floor factor (w) need to be further clarified.

Views of the Regulator

(2) With respect to claims on banks, an explanation as to why short-term claims on banks under option 2 will receive preferential risk weight while those under option 1 will not is needed.

(3) Further explanation is necessary regarding the proper risk weight to be applied to the secured portion of assets, which are past due for more than 90 days.

(4) To recognize collateral for credit risk mitigation, banks must ensure that the credit quality of the obligor and the value of the collateral do not have a material positive correlation. The Accord does not specify the level of correlation that it considers to be material, nor how to calculate the correlation.

2.6 Impact of the Accord

Views Shared by the Regulator and Banking Industry

(1) Several Asian countries are still recovering from the regional financial crisis that began in 1997. Because of the crisis, the ratings of the banks and their borrowers may be less than favorable, resulting in higher capital requirements. The broader impact of this is that the pace of the recovery process will be slowed and banks may not be able to comply with the Accord when it is implemented in 2004.

2.7 Other Comments

Views Shared by the Regulator and Banking Industry

(1) Preferential risk weights given to short-term claims on bank should be based upon the claim's remaining maturity rather than its original maturity. Using original maturity to determine which claims are short-term will motivate banks to focus more on granting short-term loans, which may eventually lead to a distortion in interest rate yield curve.

3. Internal-Rating Based Approach

3.1 Exposure Classifications

Views of the Regulator

(1) To prevent regulatory arbitrage by financial institutions, the classification of loans into the various exposure classes should be developed in such a way to allow for easy verification by bank regulators. Specifically, there remain some ambiguities within the Accord regarding whether a loan should be classified as project finance, retail, or corporate exposure. Furthermore, it is recommended that small business facilities should generally be recognized as retail exposures.

Views of the Banking Industry

(2) The Accord should provide criteria to classify loans into the exposure classes while allowing national supervisory authorities to supply the exact definition of each exposure classes. This may result in more than six exposure classes as is proposed in the Accord. In particular, there should be exposure classes for agricultural and residential loan exposures. Such a process will allow an exposure classification methodology that is consistent with the stage of economic development, industrial base, business potential, and loan quality of the specific country.

3.2 Reference Definition of Default

Views of the Banking Industry

(1) The Accord specifies several criteria that will be used in the reference definition of default. Of these, items (b), (c), and (d) of the reference definition of default properly reflect current practices within the financial sector. On the other hand, item (a), which states, in part, that "…the obligor is unlikely to pay its debt obligation", could be inconsistently interpreted and applied by financial institutions.

(2) The reference definition should more fully consider the definition of defualt currently employed within the financial sector; otherwise, it could render obsolete the existing historical data that financial institutions have accumulated on "default".

(3) The 90-day past due criteria used in the definition of default could pose a problem in developing countries where late payments occur more frequently than within developed countries, through these late payments, however, may not necessarily translate into default.

3.3 Comments on the Calibration of the Risk Weight

Views of the Regulator

(1) The current IRB risk weight calibration will unduly benefit financial institutions with higher quality loans. As a consequence, most financial institutions in developing countries that have lower quality loans will choose not to adopt the IRB approach because it does not provide the proper incentive for banks to improve their risk management practices. To remedy this shortcoming, it is recommended that the Accord contains an additional intermediary step, between standardized and IRB approach, tailored for financial institutions operating in developing countries to allow an achievable bridging path towards IRB subsequently. This would be more incentive-compatible with the Accord's ultimate aim of improving bank's own capability.

(2) Creating an additional exposure classification for residential loans – as discussed above – and having a separate risk weight function for them will allow the maturity for other retail credits to be reduced from the current assumption of three years to a more appropriate maturity level.

Views of the Banking Industry

(3) A capital requirement estimation performed by one foreign branch indicates that the capital charge required by the IRB approach could be greater than that required by the Standardized approach. This foreign branch is of the opinion that the IRB risk weight calibrations are too conservative.

(4) The proposed calibration is designed to cover both unexpected and expected losses. This may be inappropriate since financial institutions normally cover part of their expected losses within the product's pricing and will have already provided (established a reserve) for identified losses. As a consequence, the proposed risk weights may lead to double counting.

(5) The assumed 3-year maturity in the foundation IRB approach is too conservative when one considers the relatively small volume of long-term loans in the portfolios of most banks. Furthermore, the Accord should provide additional detail on the choice of a 3-year maturity.

(6) With an objective to have banks using IRB approach to maintain enough capital in order to receive a rating of 'BBB-', loss coverage target (99.5% confidence and average asset correlation of 0.20), the basic assumption to come up with risk weight function, set by Basel Committee is too high for some small banks in developing countries.

3.4 Comments on Minimum Requirements

Views of the Regulator

(1) The minimum requirements for use of the IRB approach are certainly appropriate and will help to strengthen the risk management practices of financial institutions. Nevertheless, financial institutions in developing countries are generally not ready to implement the IRB approach because of their medium to small size and limitations resulting from legal and accounting infrastructures. This will place developing countries and their financial institutions in a disadvantaged position and is inconsistent with the original intention of the Accord – to create a level playing field among financial institutions around the world. The Accord should consider the major constraints and obstacles to adoption of the IRB approach across all countries – particularly those that are less developed – and provide a system that will allow an equal opportunity for implementation of the IRB approach in all countries.

Views of the Banking Industry

(2) The Accord should permit developing countries such as Thailand whose banks have the potential to implement the IRB approach to meet the minimum requirements in a phased-in manner. The Accord could classify the minimum requirements as (1) *Core Requirements* which financial institutions must meet so as to begin using the IRB approach and (2) *Additional Requirements* that should be achieved within an appropriate timeframe after implementation of the IRB approach.

With respect to the required market disclosures, it will provide too much information for investors. Moreover, some disclosures relate to proprietary information concerning the bank's internal model. It is recommended that the information disclosed not include all of the parameters in the process but only the end-results such as the average risk weight and capital required for each exposure class. Furthermore, the disclosures should be consistent with US-GAAP or IAS.

3.5 Other Comments

Views of the Regulator

(1) Developing countries will face difficulties meeting the information requirements associated with calculating the probability of default. The BIS should provide additional guideline describing how financial institutions in developing countries can improve the quantity and quality of their data over the next three years.

Views of the Banking Industry

(2) The BIS should broaden its list of eligible collateral for foundation IRB approach. Particularly, mortgages on real property and other physical collateral, in addition to residential and commercial real estates, should be included.

4. Asset Securitization

4.1 Explicit Risks - Treatment for Originating Banks

Views of the Regulator

(1) The BIS should clarify whether or not the capital charge for first and second loss position in a credit enhancement can exceed the capital charge if the assets were held on the balance sheet.

Views of the Banking Industry

(2) Owing to differences in laws, regulations, and accounting standards in different countries, the minimum requirements pertaining to “clean break” should be relaxed. For example, in Thailand there are limitations on asset transfers.

(3) The BIS should allow originators who provide credit enhancement to calculate their capital charge by using a risk weight derived from the riskiness of the asset pool instead of deduction of the full amount of the enhancement from capital. This is considered overburdensome.

(4) When there is a securitization with an early amortization, a conversion factor of 10% is applied. The Accord should describe the rationale behind this conversion factor.

4.2 Risk Weights on ABS - Treatment for Investing Banks

Views of the Regulator

(1) The Accord should set the risk weight for ABS equal to the risk weights for corporates with a similar rating. The Accord should also set the same standards for unrated claims and unrated ABS. In the Accord, unrated claims receive a risk weight of 100% while unrated ABS must be deducted from capital.

4.3 Liquidity Facilities - Treatment for Sponsoring Banks

Views of the Banking Industry

(1) The Accord should permit sponsoring banks that provide liquidity facilities to use the so-called look through approach as is permitted for investing banks. Without such an approach, deduction of first loss position from capital is deemed excessive.

4.4 Additional Comment on Securitization in the IRB Approach

Views of the Regulator

(1) The practices of the issuing bank are in some cases not in accordance with the investing bank. For instance, an issuing bank must deduct the first loss position from capital regardless of the underlying asset. Conversely, an investing bank is permitted a more risk sensitive approach.

5. Operational Risk

5.1 Definition

Views of the Regulator

(1) With respect to external events, particularly natural disasters, the capital charge should be less than other types of occurrences, i.e. human error or system failures, as these natural occurrences may not have any adverse effect on the operation of the financial institution. In addition, damages resulting from these incidents may vary across countries.

Views of the Banking Industry

(2) Since the Accord defines operational risk to include legal risk, the definition should be sufficiently clear to prevent any additional capital charge arising from an inability or difficulties in the differentiation between operational risk and credit risk.

5.2 Calculation – General

Views of the Regulator

(1) Given that small-sized banks may engage in less complex financial activities than internationally active banks and therefore, have less operational risk, the Accord should reconsider the current total minimum regulatory capital (MRC) figure (20%) used as the basis in computing the alpha, beta, and gamma factors for these institutions.

Views of the Banking Industry

(2) Establishing a universal/global standard using data from the G-10 countries may be unjustified for smaller banks in developing countries. For example, imposing the use of the midpoint of relative weightings for each business line when calculating β may not be sufficiently risk sensitive for those financial institutions with a small number of activities within each business line.

5.3 Basic Indicator Approach

Views of the Regulator

(1) Smaller banks, due to the less sophisticated financial activities, may only experience a small amount of operational risk relative to larger banks. The Accord indirectly requires these smaller banks to maintain higher capital cushion against their operational risk.

(2) The BIS should disclose the methodology used to compute α.

Views of the Banking Industry

(3) Even though the Accord allows a transition period before the actual implementation of the operational risk requirements, its implementation immediately after the transitional period will still have an impact on financial institutions.

5.4 The Standardized Approach

Views of the Regulator

(1) The BIS should disclose the methodology used in determining the range of relative weightings in each of the business lines.

5.5 Internal Measurement Approach

Views of the Regulator

(1) The BIS should disclose the methodology used in computing γ.

Views of the Banking Industry

(2) As each parameter may be correlateed, the Accord should not simply sum operational risk across business line/type to arrive at the capital charge for operational risk.

5.3 Qualifying Criteria

Views of the Regulator

(1) The BIS should provide guidelines for supervisors to use when validating the qualifying criteria requirements. For example, guidelines to assess the effectiveness of the risk reporting system.

5.4 The Floor Concept

Views of the Regulator

(1) The floor concept may cause a disincentive for financial institutions to apply a more advance approach.

Views of the Banking Industry

(2) If the floor concept is to be introduced, it should be set at a level lower than the Basic Indicator Approach.

5.5 Outsourcing

<u>Views of the Regulator</u>

(1) The BIS should clearly specify the methodology and the amount of capital reduction allowed when outsourcing is used. This is particularly important in cases where the service provider is not a financial institution, which maintains capital in a manner not similar to a bank.

6. Principles for the Management and Supervision of Interest Rate Risk

<u>Views of the Regulator</u>

The principles for the management and supervision of interest rate risk are sound. The Basel Committee should, however, issue more detailed guidelines and instructions to enable both the supervisor and financial institutions to comply with principle 1 – 10. For example, the Basel Committee should issue a detailed supervisory manual for each principle. It may also want to consider providing technical support for guideline(s) that require special knowledge; for example the rationale behind and the methodology to be used, when calculating the Standardized Interest Rate Shock (principle 14) and to determine an Outlier Bank (principle 15).

7. Market Discipline

7.1 Materiality

<u>Views of the Regulator</u>

(1) The Accord should establish guidelines or further elaborate on the concept of "Reasonable Investor Test," as it may vary from one country to another.

7.2 Elements to be Disclosed

<u>Views of the Regulator</u>

(1) Although the Accord had already made an attempt to resolve the issue of proprietary information, core qualitative disclosure on the risk management process of the financial institution as imposed by the BIS may nonetheless undermine its competitive position.

7.3 Frequency

<u>Views of the Banking Industry</u>

(1) The frequency of disclosure as required by the Accord may not be justified from a cost-benefit standpoint.