CENTRAL BANK OF MALTA

COMMENTS

ON

THE PROPOSED

NEW CAPITAL ACCORD

May 2001

PROPOSED NEW CAPITAL ACCORD

PILLAR I – MINIMUM CAPITAL REQUIREMENTS

A. CREDIT RISK – THE STANDARDISED APPROACH

1. INDIVIDUAL CLAIMS

(i) Claims on sovereigns (Main Doc., pg. 7, para. 23)
(Standardised Approach supporting doc, pg. 8, para. 37)

While claims on unrated sovereigns attract a risk weight of 100%, exposures to sovereigns rated ***below B-*** attract a higher risk weight (150%). This could create an incentive for banks to invest in unrated sovereigns rather than ***below B-*** sovereigns. While this concept is acceptable in the case of corporates in line with paragraph 37, the same principle should not be applied in the case of sovereign ratings.

(ii) Claims on banks (Main Doc., pg. 9, para. 29 – 33)

The Standardised Approach offers two options to risk-weight claims on banks. Option 1 is based on the credit assessment of sovereigns whilst Option 2 bases the risk weighting on the external credit assessment of the bank itself. The latter method is therefore more risk sensitive since the risk weights are based on an on-going examination process carried out on individual bank risk profiles by ECAIs. On the other hand the use of option 1 appears to dilute the scope for risk analysis on claims on banks since this puts all banks in one category irrespective of the different risk profiles of banks within the same country. Therefore, the use of option 2 appears to be more equitable.

2. CREDIT RISK MITIGATION IN THE STANDARDISED APPROACH

(i) Higher Risk Categories (Main Doc., pg. 11, para. 39)

In calculating the unsecured portion of any asset that is past due for more than 90 days, net of specific provisions, neither commercial nor residential property is recognised as being eligible for credit risk mitigation purposes. It should be noted that in small countries concentration of commercial and residential property as collateral is normal and inevitable. Hence, the application of a 150% risk bucket on the unsecured portion of past due assets could be quite onerous on the banks. It is suggested that either the risk weight is lowered or different percentage bands applied

according to whether the collateral is in the form of residential or commercial property.

(ii) Definition of Collateral (Main Doc., pg. 16, para. 64)

(Standardised Approach supporting doc, pg. 16 para 88)

The words "***or a third party***" could be added at the end of the second bullet to the definition of a collateralised transaction to read "***the exposure or potential exposure is hedged in whole or in part by collateral posted by the counterparty or a third party***". It should be noted that collateral could also be posted by a third party i.e. not necessarily by the counterparty.

(iii) Eligible Collateral (Main Doc., pg. 17, para. 76)

The list of eligible collateral could be extended further to capture other types of collateral which are similarly easily liquidated. For example, "***gold***" could be extended to read "***gold and other precious metals***".

(iv) Collateral – the comprehensive approach

(Standardised Approach Supporting Doc., pg. 23, para. 132)

In the comprehensive approach a floor factor denoted ***w*** is applied to the portion of the exposure secured by the adjusted value of collateral. This, therefore, implies that for example even where an exposure is more than adequately collateralised by cash it is still subject to a minimum haircut of 0.15. It should be noted that under the simple approach and through on-balance sheet netting, the Committee has already recognised that cash collateral under certain conditions could attract a 0% risk weight. Consequently, it is suggested that a ***w*** of zero could be considered for cash collateralised transactions under the comprehensive approach.

B. CREDIT RISK – THE INTERNAL RATINGS BASED (IRB) APPROACH

1. CORPORATE EXPOSURES

(i) Treatment of maturity - the foundation IRB approach

(IRB Supporting Doc., pg. 26, para. 125)

It is noted that banks that provide longer-term loans have portfolio maturity profiles with an average maturity higher than the three-year period proposed by the Committee. It is therefore suggested that another list of benchmark risk weights is published for a longer average maturity portfolio; for example seven years. The national supervisor should then be given the option to apply the average maturity profile that is most relevant to a particular bank.

2. RETAIL EXPOSURES

(i) Definition (IRB Supporting Doc., pg. 56, para. 270)

The current proposal allows maximum thresholds for retail exposures to be set on a national basis, subject to supervisory discretion. This principle is preferred to setting global limits. However, it is suggested that this threshold should only apply to restrict the size of small-business loans that could be classified as retail.

(ii) Maturity (IRB Supporting Doc., pg. 66, para. 324)

The suggestion [in point B1(i) above] of another maturity profile for corporate exposures could equally be applied to retail exposures, particularly mortgage lending.

3. EQUITY EXPOSURES

(i) Definition of default for equity (IRB Supporting Doc., pg. 79, para. 384)

One way of defining equity default could be when the market price falls below the net asset value.

C. OPERATIONAL RISK

1. DEFINITION (Operational risk supporting doc, pg. 2, para. 6)

Although acceptable, the quoted definition of operational risk seems quite generic. Further categorisation of operational losses into internal and external factors and allocation of such losses by business lines could be more helpful. Thus, it is proposed that a guidance list based on industry surveys and detailing the above-mentioned loss categorisations could be drawn up by the Committee and incorporated within the definition. Alternatively, a similar guidance list could be drawn up by national supervisors and be based upon the result of comprehensive risk management exercises carried out with the banks.

It is further noted that reputational risk is not included in the definition of operational risk. Although very difficult to measure, reputational risk could have significant adverse effects, which far outweigh the actual losses arising from operational risk. Therefore, owing to its importance, reputational risk cannot be ignored.

(i) Recognition of provisions and loss deductions
(Operational risk supporting doc, pg. 3, para. 14)

It is suggested that provisions and loss deductions should be included in the calculation of capital requirement. General provisions for bad and doubtful loans normally form part of own funds. Similarly, provisions effected to cover operational

risk could either be added with other provisions to own funds or else either deducted from the gross income under the basic indicator approach, or deducted from the *Indicator* in the second part of the calculation of the standardised approach.

2. GENERAL CONSIDERATIONS

(i) The Continuum Concept

(Operational risk supporting doc, pg. 4, para. 17)

It is noted that in the operational risk methodology a bank could allocate some business lines to the Standardised Approach and others to the Internal Measurement Approach. However, banks are prohibited from moving back to simpler approaches once they have adopted more advanced approaches. It is suggested that banks should be allowed to revert to the simpler approach subject to supervisory approval especially where the banks are in the process of upgrading to a more sophisticated approval. Such approval would be granted where a bank justifiably demonstrates to its supervisor that it wants to revert to a simpler approach because the total costs in implementing and maintaining an advanced approach would become unsustainable. Consequently, any benefits achieved through lower capital requirements once an advanced approach is implemented would be outweighed by the costs.

This suggestion appears to be more relevant in the case of relatively small banks. It can be envisaged that such banks would be incentivised more to adopt the evolutionary approach if they are assured that reverting to simpler approaches, if justified, is possible.

3. BASIC INDICATOR APPROACH

(Operational risk Supporting Doc., pg. 6, para. 23)

Under this approach banks should hold capital for operational risk equal to a fixed percentage of gross income set at around 30% (***alpha factor***). This percentage is considered quite onerous in terms of the capital haircut and is not sensitive to the different levels of operational risks that are present in banks of similar size. Since the application of Pillar II is a critical complement to the minimum capital requirements set out in Pillar I, whilst Pillar III emphasises that market discipline enforces capital adequacy and other supervisory effects, the risk management process of banks should improve. The safety and soundness of financial systems should be promoted and this would mean that banks would be better guarded against all types of risks including operational risk. Therefore, the improvement of the risk management framework through the process of implementing the Accord should also be taken into consideration when determining the level of the ***alpha factor***.

4. THE FLOOR CONCEPT (Operational risk Supporting doc, pg. 14, para. 45-47)

If the Committee decides to introduce the use of the ***floor concept*** there is consensus for the second approach whereby the Committee would set the floor by establishing minimum levels of the Expected Loss calculation, as this appears to be more logical and accurate. However, it is noted that this floor would be calculated on the same data used for the internal measurement approach hence the accuracy of the floor depends on the reliability of the data.

5. RISK TRANSFER AND MITIGATION
(Operational risk Supporting Doc., pg. 15, para. 50)

Insurance cover should be recognised as a risk mitigation technique and in principle should be reflected in the capital requirement for operational risk. However, it is opined that a 100% risk mitigation is not justified owing to the possible replacement of operational risk with counterparty risk. Thus, any initiative by the Committee to recognise and develop further this principle is welcomed.

PILLAR II – SUPERVISORY REVIEW PROCESS

It is noted that the burden on regulators will increase significantly both due to the responsibilities emanating from the supervisory review process set out in Pillar II and also through the adoption of the IRB and the Operational Risk framework. Care should also be taken that responsibilities of supervisors do not appear to encroach in any way on the banks' management responsibilities.

1. INTEREST RATE RISK IN THE BANKING BOOK

It is noted that supervisors have to ensure that banks have sufficient capital to support interest rate risk otherwise they must require banks to reduce risk or hold additional capital accordingly. The fact that no specific capital charge has been established under Pillar I could undermine the level playing field proposed in this area. Similarly, further work by the Committee might be necessary to mitigate any possible dislevelling of the playing field.

PILLAR III – MARKET DISCIPLINE

In small economies with a limited number of large corporations in particular sectors, certain disclosure requirements, in particular the publishing of details of past due / impaired loans, could lead to disclosure of proprietary data.

GENERAL COMMENTS

- The discretion given to national supervisors in certain areas of the Accord may lead to different interpretations by different authorities and could therefore hinder the achievement of a **level playing field** and possibly lead to regulatory arbitrage. Certain phrases used could be changed or better defined since these may be open to various interpretations thus contributing to different applications of the Accord. Such phrases include *"reasonably short period of time"* (main doc, pg 34, para 159), *"relatively small"* (main doc, pg 87, para 519), *"short term"* (main doc, pg 99, para 569), *"on a regular basis"* (Interest rate risk supporting doc, pg 21, principle 11).

  Moreover, under operational risk, supervisors are given the discretion to define different *beta* and *gamma* factors thus providing opportunities for inconsistencies between different countries.

- The IRB approach provides incentives for innovation by banks to improve their risk sensitivity analysis and practices. However, in the case of small banks, the cost of implementing and maintaining the said approach may exceed the benefits achieved through capital savings.

- The need for additional human resources in the supervisory / regulatory functions would penalise particularly smaller countries where technically proficient personnel are relatively scarce. This comment has to be seen in the perspective of small economies where only a handful of banks can be thought of as being significant. Moreover, only one or two may ultimately use advanced techniques such as the Advanced IRB approach. In view of such limitations, this could result in an inability to cover all the necessary aspects of the Accord. Therefore, regulatory authorities in such small jurisdictions can never achieve the cost-effectiveness of their counterparts in much larger countries. Moreover, the onerous training requirements necessitated through implementation of the Accord will be concentrated within the same small pool of supervisors.

New Capital Accord Working Group
Banking Regulation & Supervision Division

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