Comments on the Proposed New Capital Accord

The Central Bank of Sri Lanka (CBSL) has held extensive discussions with the banking community in Sri Lanka before finalising the comments summarised below. The comments submitted by us include the suggestions/views of the banks, as well as our own comments from a supervisory viewpoint. In principle, the CBSL is in favour of the proposals in the new Accord. However, its main concerns relate to the practical difficulties and resource constraints relating to the implementation of the new proposal.

The under mentioned comments are summarized under the following headings:

(A) Clarifications required relating to the new Capital Accord
(B) Issues not addressed or deficiencies in the new Capital Accord
(C) Practical Difficulties in implementing the proposals in the new Accord

<u>Clarifications on the new Capital Accord</u>

Could the regulator allow a bank to use a combination of the Standardised Approach for some advances and the Internal Ratings Based Approach for others?

<u>Issues not addressed or Deficiencies in the new Capital Accord</u>

1. The proposals in the Capital Accord do not specifically address provisioning requirements. Unless the Basel Committee’s standard provisioning requirements for loan losses are complied with by all countries, there will be no uniformity or comparability of the capital base used in the computation of the capital adequacy ratio (CAR). For example, in a supervisory regime with less stringent provisioning requirements, the CAR would show a relatively higher value.

2. It would be desirable if the Basel Committee issues detailed guidelines as to how supervisors should assess the internal rating systems of banks as part of the supervisory approval process.

3. There should be detailed guidelines for the assessment of external credit assessment institutions (ECAI) by supervisors, and the disclosures required to enhance transparency of the approval process of ECAI.

4. The 100 per cent risk weight for all unrated claims could create an anomaly, since borrowers of a lower credit standing, who do not expect a good rating will opt to be unrated rather than obtain a lower rating in order to avoid a 150% risk weight. Further, it appears inequitable for a bank providing facilities to a poorly rated firm incurring a higher capital cost than one supporting a firm of similar credit strength which chooses to be unrated.

5. Claims on other banks should be risk weighted based on the individual bank rating. The option of risk weighting all banks based on the country rating would go against the main objective of the new capital accord, namely enhancing the competitive equality with more risk sensitive risk weighting.

6. The Basel Committee should consider the advantages of a more graduated series of risk weights (0, 20, 50, 75, 100, 125 and 150%) as against the increased complexity in the calculations.

7. A bank should be required to disclose the CAR stipulated by the supervisor along with their actual CAR where the supervisor has stipulated a higher capital adequacy ratio for that bank. Otherwise, banks that are required by the supervisory authority to maintain a higher than normal CAR in view of their higher risk profiles might appear to be stronger than they actually are.

8. The Basic Indicator Approach and the Standardised Approach for computation of the capital charge for operational risk seems to be inconsistent with the main objective of the new Accord, namely, enhancing the competitive equality with more risk sensitive capital requirements. It is suggested that the capital charge for operational risk be specified by the supervisor based on the Supervisory Review Process in Pillar 2.

9. The proposal to extend collateral to all financial assets and the proposed extension of netting is welcomed. However, exposures guaranteed by export insurance agencies in countries rated AAA to AA- should be risk weighted at 0%, and exposures guaranteed by export insurance agencies in countries rated A+ to A- should be rated at 20%.

<u>Practical Difficulties in implementing the Proposals in the new Accord</u>

1. The Internal Ratings Based Approach would require advanced computer software. Alternatively, it may require extensive customisation to existing software. Implementation and testing of the software would take time and money. Therefore, considering the far reaching changes required to the systems, the timeframe for implementation could be extended by an additional one or two years (unto 2005 or 2006).

2. In Sri Lanka, at the moment, there is only one credit rating agency, which was recently established, and as such this could create a monopoly situation and the cost of external ratings could be relatively higher. Further, for the supervisors, there would not be a panel of rating agencies to choose from, based on the assessment criteria specified in the Accord.

3. It is suggested that a floor be set for limiting the requirement of a credit rating for small and medium scale borrowers, and rate them at 100%. In the alternative, a portfolio approach to assessing the credit risk of medium to small-scale borrowers may be preferred to an individual rating approach.

4. Sri Lankan banks have suggested that the Supervisory Authority should introduce a uniform Internal Rating system to be used by all banks, with a view to ensuring consistency and uniformity in the rating process by different banks, and also to reduce the cost of implementing an Internal Rating System. As such, the Basel Committee may consider whether it should specify such an internal rating system for adoption by the Supervisory Authority, if necessary.