Comments on the New Basel Capital Accord

The Central Bank of Trinidad and Tobago welcomes the Basel Committee's attempt to improve the risk sensitivity of the Capital Accord. While the 1988 Accord afforded some means of assessing capital allocation for credit risk exposure, its method was at best rudimentary and has long been surpassed by market developments.

In reviewing the proposed Accord, the Central Bank has focussed comments on those approaches which will be utilised in measuring credit risk and operational risk in Trinidad and Tobago when the Accord is implemented. Given the size and level of development of institutions and the financial sector, the standardised approach to measure credit risk and the basic indicator approach for operational risk are the most appropriate methods for Trinidad and Tobago. Comments on the approaches have been limited to areas of concern, their possible effects and alternative suggestions for improvements.

With regard to the standardised approach to measuring credit risk, the proposed use of assessments by external credit assessment institutions and an additional risk weight category should improve the risk sensitivity of the Accord. However, the level of risk sensitivity is limited by the number and dispersion of the credit ratings and risk weights utilised.

A review of the proposed credit ratings and attendant risk weights reveals that most of the differentiation occurs at the higher and lower quality end of the credit risk spectrum. Relatively few of any bank's customers will attract ratings higher than "A+ to A-" and thereby be eligible for risk weights of 50% and under or lower than "below B-" with risk weight of 150%. As such the risk adjusted asset profile of most institutions will be the same as under the previous Accord. This effectively limits the stated intention of improved risk sensitivity. As a possible alternative to this situation, the Committee could consider increasing the number of risk weight categories to reflect historical loss experiences across several countries with suitable prudential margins incorporated for unexpected loss.

The standardised approach uses assessments by external credit assessment institutions as independent measurements of credit risk. However, it should be noted that in most developing countries, external credit assessments may not be available or in compliance with international requirements. In Trinidad and Tobago, most corporate and individual clients which form the majority of banks' customers are unrated. Implementation of the new Basel Capital Accord will require the development of external credit assessment institutions in compliance with proposed eligibility criteria in country, or the employment of international external credit assessment institutions. In the context of a worldwide effort to comply with the Accord, both alternatives may be punitively expensive for local financial institutions and unattainable by the proposed implementation date.

Further, the proposed system of risk weights provides an incentive for banks to encourage their problem clients to remain unrated and incur a 100% risk weight rather than be rated with a possible 150% risk weight resulting in a greater capital charge.

A review of the risk weights in the standardised approach reveals that the residential property risk weight of 50% has remained unchanged from the previous Accord. A 50% risk weight translates into a 4% capital charge which is high when compared with historical loss experience on residential mortgage portfolios. The Central Bank of Trinidad and Tobago utilises a range of 0.5% to 4.5% when estimating potential loss in the unexamined position of a portfolio during on-site examination. Residential mortgage portfolios have typically recorded a low level of loss. It is recommended that the Committee consider allowing supervisory discretion to vary the residential mortgage risk weight where justified by historical loss rates and market characteristics with a floor or minimum risk weight.

The standardised approach while seeking to enhance risk sensitivity does not take into account any capital charge for portfolio concentration. Historical experience has demonstrated that portfolio concentration has been a significant contributor to most bank failures. While there is some provision for portfolio concentration or granularity in the internal ratings based approach, it is expected that most countries will utilise the standardised approach of the Capital Accord for sometime and will not be subject to any capital requirements for portfolio concentration. At present, in Trinidad and Tobago, licensed financial institutions are subject to legislated concentration limits based on their capital. It is recommended that the Committee consider an additional capital charge for large exposure to

a single or related borrower to be applied at a supervisory discretionary limit expressed as a percentage of capital or of the portfolio.

For the first time the Capital Accord proposes a capital charge for operational risk. The approach that will be applicable to Trinidad and Tobago will be the basic indicator approach which as its name implies is straightforward. However, the system to gather information necessary for the formulation of the capital factors will need to be established prior to implementation.

MAY 31, 2001
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