

RESPONSE TO PROPOSALS FOR

A NEW BASEL CAPITAL ACCORD

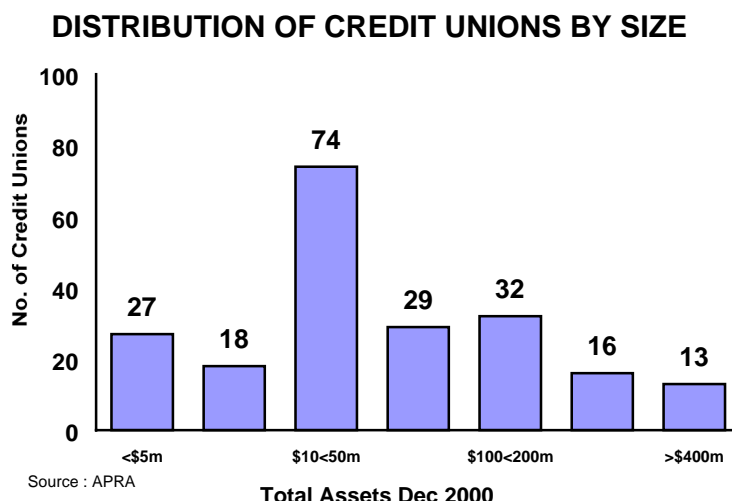
CREDIT UNION SERVICES CORPORATION

MAY 2001

RESPONSE TO PROPOSALS FOR A NEW BASEL CAPITAL ACCORD

1. BACKGROUND

- 1.1 CUSCAL is owned by 185 of Australia's 209 credit unions. In international terms, a credit union, even the largest, is small. The asset distribution of credit unions is not even: the top ten credit unions represent 42.8% of assets, the top 20, 64.1%. The chart below illustrates their distribution.



- 1.2 While the number of credit unions has been declining (through merger) since the early 1980s, credit unions remain an integral part of the Australian finance sector providing an alternative source of financial products and services to consumers. Credit unions' provision of financial products and services is characterised by a high degree of co-operation. Their participation in national financial markets is facilitated through industry owned centrals, of which CUSCAL is the largest. This arrangement, ie co-operative participation of local credit unions and a national central, is a feature of credit union Movements and co-operative banking groups around the world. Through these arrangements, relatively small local credit unions participate in national financial markets and are able to share and transfer risk on an industry basis.

2. INTRODUCTION

- 2.1 CUSCAL welcomes the review of the 1988 Basel Capital Accord and supports the mutually reinforcing three pillar structure promoting the theme of increased risk sensitivity in capital planning. The principle that financial institutions should have robust internal systems for identifying, measuring and managing risk is sound and fits well with the holistic approach to prudential supervision.
- 2.2 CUSCAL also supports the intention of the Basel Committee to create a set of principles which "are intended to be suitable for application to banks of varying levels of complexity and sophistication"¹ and to retain the minimum ratio of capital to risk weighted assets including operational and market at 8%.²
- 2.3 Whilst supporting the general principles of the New Capital Accord, CUSCAL has several concerns about the potentially adverse impact of the New Accord if the principles are not applied with sensitivity to the diverse and co-operative nature of the credit union movement.

¹ Para 8 Overview of The New Capital Accord

² Para 9 Overview of The New Capital Accord

- 2.4 CUSCAL's response to the proposals reflect our unique position as both an ADI in our own right and as the central banking and industry advocate body for the majority of Australia's 209 credit unions.
- 2.5 There are five main issues which are of concern to credit unions. They are:
 - 2.5.1 That larger financial institutions should not gain a regulatory advantage over smaller institutions because the nature of their operations prescribes a more sophisticated approach to risk management and they have the funds and capacity to develop sophisticated models under internal rating based (IRB) approaches;
 - 2.5.2 The potential disadvantage to credit unions posed by the use of external ratings agencies in determining risk weights;
 - 2.5.3 The disproportionately high risk weighting on mortgage secured housing loans relative to the risks presented by these loans;
 - 2.5.4 The potential impact of a specific charge for operational risk and the blunt instruments proposed for measuring such risk.
 - 2.5.5 The nature, cost and effectiveness of disclosure requirements

3. INTERNAL RATING BASED APPROACHES

- 3.1 CUSCAL agrees that financial institutions should be encouraged to develop models which accurately measure and monitor the risks to which they are exposed. The sophistication of these models should be commensurate with the complexity of the organisation and the nature of the risks inherent in the organisation. For example, small financial institutions which provide basic retail deposit products and manage a loan book comprised largely of mortgage secured assets and a small exposure to unsecured personal loans is unlikely to require complex statistical models to measure and monitor risk.
- 3.2 The absence of sophisticated models does not necessarily indicate a deficiency in the risk management of these institutions and should not lead supervisors to impose more onerous capital requirements on this basis. Nor should such arrangements provide regulatory relief to larger institutions where the nature of their business dictates a higher degree of sophistication in the measuring and monitoring of risk.
- 3.3 CUSCAL strongly supports the notion that strong capital ratios should be complemented by robust internal risk measurement and management systems. However, if the IRB approach is seen to reward the development of substantial quantitative models, this has the potential to actually increase risk in certain institutions who may be tempted to redirect their limited management resources towards pursuing quantitative models in the hope of gaining regulatory relief. Where such activities do little to alter the real risk profile of the business the improvement to risk management processes is questionable.
- 3.4 A stated intention of the BIS Committee is that the overall capital of the industry would not increase. If sophisticated risk management models brings about regulatory relief to larger institutions, the burden of capital across the industry would shift with credit unions being required to hold a greater proportion of the industry capital - disproportionate to the level of risk they present to the system.
- 3.5 Credit union risk needs to be understood within the context of the credit union system. The high level of co-operation among credit unions has important implications for risk management. An individual credit union's risk profile cannot be fully understood without both an understanding of the industry based risk management systems that it participates in, and an understanding of the structure of the industry as a whole.

- 3.6 While on its own, a credit union might have difficulty managing the risks that attend its small size (such as geographic or industry sector concentrations, or lack of balance sheet diversification), participation in industry structures offers it a considerably expanded range of risk management options.
- 3.7 Examples which demonstrate the range of industry based risk mitigation techniques provided through CUSCAL to its members are:
- liquidity support (stand-bys, overdraft facilities)
 - balance sheet management (securitisation and wholesale funding)
 - emergency liquidity and solvency support (CUFSS)
 - risk management and capital advisory services
- 3.8 This system-wide context for understanding the risk profile of individual credit unions is likely to become more important over time. While the levels of credit union aggregate capital are very healthy (risk weighted 14.7%), the shift in loan portfolio towards housing finance (now exceeding 60% of loan assets) masks a slight proportional decline in reserves. More importantly, continued strong competition and declining margins have resulted in suppressed industry ROA (0.63%). Efforts to address this situation focus on reducing the industry's cost base (81% exp/inc) and increasing non-interest income.³ Structural changes may also be required to meet these competitive pressures.
- 3.9 These developments imply rising and more complex combinations of operational, reputation and legal risks for credit unions, and the management of these will be a challenge for credit unions and for supervisors. From CUSCAL's perspective, understanding combinations of risk at the level of the credit union system will become increasingly important for CUSCAL's own risk management, and for that of individual credit unions. Similarly, APRA's sensitivity to the changing risk environment will be essential to the successful implementation of the Basel supervision principles.

4. USE OF EXTERNAL RATINGS

- 4.1 CUSCAL acknowledges that recognising the ratings of external agencies within the standardised risk weight system will give greater precision to the Accord by recognising the diverse creditworthiness of different corporates and ADIs. This initiative will have considerable impact on banks that have exposures to other ADIs and this is of particular concern to CUSCAL and credit unions.
- 4.2 Although CUSCAL enjoys an excellent credit rating (AA-) from Standard and Poors, no single credit union in Australia has a credit rating and, it remains unlikely that any credit union would be successful in doing so. One of the difficulties for ratings agencies is that historical default data for prudentially supervised ADIs is virtually non-existent. Additionally, ratings agencies have traditionally had difficulty coming to grips with the unusual characteristics of co-operative banking and credit unions.
- 4.3 The formal inclusion of the ratings of external agencies within the risk-weight tables has potentially far-reaching consequences for credit unions and for CUSCAL. For instance, an increase in the risk-weight of loans outstanding to credit unions (which are un-rated) from the current 20% to 50%, would result in an increased capital charge of approximately \$23 million to CUSCAL. Conversely, a fall in CUSCAL's own credit rating would result in an increased capital charge to credit unions of approximately \$43 million.
- 4.4 Of greater concern to CUSCAL is the likely effect on credit unions' access to liquid funds. Although the liquidity requirements of most credit unions are met by CUSCAL,

³ All figures quoted as at December Quarter, 2000.

credit unions sometimes choose to source standby lines and other facilities from Australian banks as part of their liquidity risk management strategies. A move to risk weight claims on ADIs according to their external credit rating, or a default of 50% for un-rated ADIs, will make it less attractive for banks to offer these facilities to credit unions and will therefore restrict credit unions' access to liquid funds.

- 4.5 The adverse reaction experienced from banks when credit unions came under the depositor protection provisions of the Banking Act demonstrates that banks are not inclined to rely on the credit worthiness of individual credit unions if they perceive there is a diminution of collateral in relation to the facility provided.
- 4.6 CUSCAL therefore views the proposal to include external credit ratings in the risk weight tables for ADIs with some concern and caution. If the effect of introduction on unrated credit unions is to unduly restrict their access to credit, this would clearly be undesirable from both a commercial and a prudential standpoint. The proposal to recognise short maturity for claims on banks with a more favourable risk weighting would go some way to assist small ADIs seeking liquidity support facilities but twelve months would be a more realistic time frame.
- 4.7 There are some attractions in the approach outlined Option One, where claims on banks are allocated a risk weight one higher than that applying to the sovereign in which the bank is incorporated. This approach at least has the merit of ensuring that there is some recognition for the quality of prudential supervision in that jurisdiction. There is a strong argument that the risk-weights should recognise the value of high quality regulatory assurance. Under Option 2, it is possible that credit to a well-run prudentially supervised ADI in Australia might be weighted as having the same approximate credit risk as household credit secured by a mortgage. While Option 1 may be difficult to implement in relation to internationally operating banks, it may be more appropriate for ADIs with purely domestic operations.

5. HOUSING LOANS

- 5.1 A risk weight of 50% assigned to mortgage backed housing loans is inconsistent with the level of risk attached to such loans in Australia. Whilst there is insufficiently detailed data regarding defaults on mortgage backed loans, accepted commercial intelligence (based on experience) is that this type of lending is among the safest investment for an ADI. Rarely do borrowers default on such loans and in the event that they do, the value of the collateral more than covers the outstanding loan, particularly in the majority of Australian capital cities.
- 5.2 Partly to take advantage of the low risk nature of the home lending, credit unions in Australia have significantly increased their activities in the this market segment over the past five years. Housing loan balances outstanding for the industry have virtually doubled to \$11,267m between December 1995 and December 2000. This represents an average annual growth rate of just under 15% which is around the same rate of growth recorded for the market overall. Credit unions now have more than 60% of their lending portfolio in housing loans and housing lending has replaced personal lending as the dominant business activity in credit unions.
- 5.3 If support cannot be gained for a reduced risk rating or national discretion, an approach similar to that outlined in the Committee's supplementary paper "Criteria in defining exceptional treatment of commercial real estate lending" would appear to provide a model which could be applied to residential mortgage lending. By establishing rigorous collateral and valuation requirements along the lines set out in the paper, discounted risk weights for residential housing could be supported internationally.

6. OPERATIONAL RISK CHARGE

- 6.1 CUSCAL supports a distinct capital charge for operational risk and has always encouraged credit unions to take account of this type of risk in capital planning. However, CUSCAL also agrees with the sentiments expressed in the technical paper that there is much work to be done before the concept of a capital charge representing operational risk can be effectively implemented.
- 6.2 The role of capital is to protect depositors and ultimately the payments system from risk. While the Accord does leave the ultimate capitalisation decision to the Board of each ADI, there is limited discussion in the Accord of the appropriate level of risk aversion and the role played by central banks and ADI boards in the determining these levels.
- 6.3 It is argued that regulatory goals should have a strong focus on the protection of the payments system and as, a secondary consideration, provide a base level of risk aversion, or risk floor for ADIs. As the majority of the sophisticated approaches presented in the Accord revolve around some form of confidence interval statistical methodology, there should be explicit recognition of the confidence level required by the regulatory framework as a risk floor.
- 6.4 The models presented for calculating an operational risk capital charge rely on successfully identifying the components of operational risk and correctly assigning a probability to various events. There are two significant flaws in this: one, it is possible that not all operational risks will be identified and two, the correlations between the risks are not adequately accounted for.
- 6.5 An alternative is to employ a top down approach to capital allocation and calculate total capital based on earnings volatility. This would then allow the application of a residual approach to estimating operational risk. The basis of such an approach is that credit risk and market risk assessments are relatively straightforward for most banks and can be calculated on data already collected, the difference between these capital charges and total capital calculated using earnings volatility is operational risk.
- 6.6 The advantage of this approach is that operational risk can be readily identified and calculated in the absence of data, which the Committee acknowledges few banks collect. It also captures strategic and reputational risks which are currently excluded from the definition of operational risk.
- 6.7 The concepts and principles underpinning the earnings volatility methodology are well accepted in the finance sector and CUSCAL has been developing a model using the residual approach to assess the efficiency of capital allocation within the organisation. Although application of the model is in the early stages, the potential for it to be a powerful and relatively direct strategic decision making tool looks very promising.
- 6.8 In addition to questioning the nature of the methodologies presented for assessing operational risk, the detail of the standardised methodology appears somewhat confused and creates the potential for misleading results. Specifically:
 - 6.8.1 The 20% value seems to have been extracted from internal economic capital allocations that could be expected to differ from regulatory capital;
 - 6.8.2 The small sample size from which the 20% was derived and the inference that "one size fits all" disregards the diverse nature of balance sheets and operational risk components;
 - 6.8.3 There is high dependency on accounting output that can vary between ADIs and in some cases may be manipulated;
 - 6.8.4 The focus for retail balance sheets is again placed on asset size as the key risk indicator. This does not appear to be any advance on the original risk weighted assets approach.

- 6.9 The more sophisticated Internal Measurement Approach outlined in the technical paper does well to start the process of identifying risk factors but provides little assistance in ensuring that all risk factors are covered.
- 6.10 Additionally, the real benefit to be extracted from such modelling is lost through the application of generic industry expected loss factor (γ) and subjective Risk Profile Index (RPI) factors. Both these variables are to be set by the Supervisor removing them from the control of the ADI which has the best capacity to measure/estimate them. The combination of the γ and RPI factors effectively conceals the confidence level required of these models. Identifying these confidence interval requirements are an important part of the debate on the effectiveness and intentions of the proposed accord.
- 6.11 It is difficult to see how the proposals presented in the New Accord can be implemented without raising the overall minimum capital adequacy ratio above 8%, especially if the risk rating on mortgage lending remains at 50%.
- 6.12 In relation to credit unions, the models presented to not account for the risk mitigation afforded by membership of an industry body which provides services such as compliance assistance, IT support, wholesale securitisation programs, etc. This was discussed earlier in section 3.

7. NATURE AND COST OF DISCLOSURE

- 7.1 CUSCAL generally supports a cautious approach to the use of disclosure and market discipline with deposit taking institutions. Without listed or traded capital, and too small to attract the scrutiny of professional analysts, market discipline on most individual credit unions is not likely to be improved by excessive market disclosure.
- 7.2 Moreover, the degree of disclosure currently required under Australian legislation and the fact that credit union shareholders are owners as well as retail depositors means that the manner of disclosure should be careful in order to increase confidence rather than add confusion.
- 7.3 Notwithstanding those concerns, CUSCAL supports the Paper's suggestion that institutions should be required to disclose in some detail the quantitative and qualitative data that supports a description of its risk profile. CUSCAL also supports disclosure of data related to capital adequacy. CUSCAL would have reservations, in the Australian context, about disclosing the level above regulatory minimum formally required of each institution by regulators.
- 7.4 In addition, CUSCAL believes there may be much more sense in the credit union industry in promoting disclosure of industry wide risk and risk management information. Standard and Poors already regularly publish a credit union industry analysis, and further development in this area could support further maturing of the relationship between the industry and financial markets.

8. CONCLUSION

- 8.1 Whilst CUSCAL is broadly in agreement with the thrust of the Accord, there are a number of concerns which arise from the taking concepts and principles designed around the operations of large internationally operating banks with complex structures and product lines and applying them to very small domestically operating financial institutions with simple structures and product lines. In particular, CUSCAL considers that:
 - 8.1.1 Larger financial institutions should not gain a regulatory advantage through the use of sophisticated risk management models
 - 8.1.2 Credit unions should not be disadvantaged by the absence of a rating from an external agency. In particular unrated institutions should have a risk

weight no more than 50% and short maturity (12 months or less) be one risk weight lower.

- 8.1.3 Criteria be developed which will allow the risk weighting on mortgage backed housing loans to be reduced;
- 8.1.4 Further work be done on the nature and detail of operational risk measurement tools to ensure the calculation of an efficient capital charge. Such work to recognise the role of an industry central in risk mitigation for individual credit unions.
- 8.1.5 The nature, cost and effectiveness of disclosure in relation to small ADIs be considered in the context of the disclosure requirements already in place.

Comments and questions on the contents of this submission may be directed to Karin Hawkins, Public Affairs, Credit Union Services Corporation, phone +61 2 9333 7579, or e-mail khawkins@cuscal.com.au.