Comments on the January 2001 Proposal of the New Capital Adequacy Framework

Introduction

The Czech National Bank welcomes the efforts of the Basle Committee to enhance the regulatory and supervisory process and thus increase the stability of the banking sector by updating the existing techniques for measuring risk, introducing new techniques and by setting capital requirements to create a cushion against risk. We also appreciate that the national regulatory authorities from non-G10 countries have been given an opportunity to participate in the preparation of the New Accord.

In many cases the New Accord offers a choice between a simple technique and a more sophisticated approach. The technical and financial resources of Czech banks are limited and therefore the more sophisticated approaches will not always be feasible, or at least not during the early period following the implementation of the New Accord. Nevertheless the New Accord presents a great challenge for the banks to raise their standards and subsequently benefit from the possibility of applying more sophisticated procedures.

We enclose a commentary on the proposed form of the New Accord. Some of the comments ask for clarification of formulations or methods where we are not sure that we understand the intended meaning of the text. Others raise a request for a change aimed either at a principal issue or at a technical point. The individual chapters have been discussed one by one with the Banking Association, which has added its own comments. These comments are sometimes in accordance with our point of view and at other times contrary to it. If the latter is the case, this is always noted in the comment.

Organisation of the Commentary

The comments are arranged into chapters according to the related areas as discussed one by one with the Commission on Banking Regulation of the Banking Association. All references are related to the main document "The New Basle Capital Accord" if not directly stated otherwise.

In each chapter the comments are divided into two categories – conceptual and technical. The comments include instances where the standpoint of the Czech National Bank is different from the standpoint of the Banking Association.

The First Pillar – Credit Risk – the Standardised Approach

part A – conceptual comments

1) The guidelines for the process of recognition of external credit assessment institutions (article 46) should be elaborated further to assume a more concrete and detailed form. This is essential for the regulators to be able to apply equal standards in the recognition process.

2) Attention should be paid to the question of treating subsidiaries of highly rated foreign banks, and possibly also subsidiaries of these subsidiaries. Is it a correct approach to derive the rating of a subsidiary from the rating of the parent company (including the alternative that the rating of the subsidiary would equal the rating of the parent company decreased by a factor reflecting the difference between the ratings of the two countries)? The existing position of the Basle Committee has been that the regulator will assess each case individually, and the rating of the parent company will be allowed for use if the parent company stands financially by the subsidiary. The crucial question is the following. What does it mean "to stand financially by the subsidiary"?

3) The proposed risk weights for claims on banks (pages 9 and 10) may give rise to pressure for the transformation of subsidiaries of highly rated foreign banks into branches and thus have a negative impact on the stability of the banking sector.

4) Where a country's rating is lowered, the national regulator should possess the authority to set a transition period for the banks to adjust to the new conditions. A requirement for an extensive capital increase and the bank's inability to respond to it promptly may result in the necessity of severe regulatory action, even though the real change in the credit risk of the loan portfolio is not as sudden as the change in rating.

5) The construction of risk weights for claims on banks under Option 2 (page 10) and claims on sovereigns is inconsistent with the generally accepted principle that the risk weight of a non-sovereign entity may not be lower than the risk weight of the respective sovereign. Is this really the intended approach?

   The Banking Association is of the opinion that the preferential treatment of short-term claims, as proposed in relation to claims on banks under Option 2, should be extended to short-term claims generally. The Czech National Bank does not share this opinion.

6) Article 52 stipulates that if there are two assessments by ECAIs chosen by a bank corresponding to different risk weights, the higher risk will be applied. We propose that if the time interval between the two assessments is no less than six months the more recent assessment should be allowed to apply.

7) The treatment of credit derivatives should also be described in the event that the bank is the party that takes the risk, i.e. the new concept should cover the conversion of the risk position into a risk-weighted asset and the inclusion of the risk position in the credit exposure.

8) We are of the opinion that insurance companies should be given a different treatment, as these companies are regulated entities.

9) The Banking Association is of the opinion that the preferential treatment of short-term claims should be related generally to residual maturity and not original maturity. The Czech National Bank does not share this viewpoint.

10) The Banking Association is concerned about the requirement to obtain legal opinions confirming the enforceability of the collateral arrangements in all relevant jurisdictions and the requirement for periodical updating (article 70). The Banking Association considers the formulation too general. The text does not specify whether the updating requirement is aimed at every single contract being collateralised in standardised form or whether it is acceptable to use one legal opinion for all contracts secured with collateral of standardised form. The Banking Association prefers the latter alternative and asks for greater accuracy in the text.

The Czech National Bank does not object to the request for greater accuracy, but does agree with the requirement to obtain legal opinions.

<u>part B – technical comments</u>

1) The stipulation of Article 24 permits lower risk weights to be applied to banks' exposures to the sovereign (or central bank) of incorporation denominated in domestic currency and funded in that currency. The notion "funded" should be spelled out more concretely as different interpretations seem to be possible in relation to the current text. Firstly, the bank having liabilities in the currency of an unspecified size, secondly, the bank having liabilities in the currency of a size that is no less than the size of the exposure to the sovereign (or central bank).

2) Article 36 encourages regulators to increase the standard risk weight for unrated claims in countries with higher default rates. The notion "higher default rate" should be put in more concrete terms; the current vague formulation allows unequal approaches to countries with comparable default rates and unequal approaches to the same country by two national regulators.

3) Article 72 uses the concept "material positive correlation between the credit quality of the obligor and the value of the collateral". This needs further specification.

4) The Czech National Bank does not understand why the values of the w-factor are different for guarantees and credit derivatives (articles 143-145).

5) The text of the last paragraph of article 39 should be put in more concrete terms in the following sense. It is not clear whether the risk weight 150% applies only to an unsecured portion that is past due for more than 90 days, or to the whole unsecured part of an asset at least one portion of which is past due for more than 90 days.

6) Article 78 contains a set of criteria for unrated bonds issued by banks to be treated equivalently to those assessed A/BBB. Considering the construction of the parameters in article 88 we assume that condition c in article 78 also includes the BBB- category.

Wherever this interpretation is intended it should be expressed directly, otherwise there arises a danger of misunderstanding.

7) We assume that the notion "market price volatility" in the first sentence of article 92 (concerning the use of internal models for setting haircuts) includes both the volatility of the exposure H_E and the volatility of the collateral H_C. If this interpretation is intended it should be expressed directly.

8) The formulation of the text in article 81 should be corrected to make it consistent with the formula on page 19 (the second line from the top).

The First Pillar – Trading Book Issues

part A – conceptual comments

1) If the regulatory authority allows lower risk weights for exposures to the sovereign (or central bank) denominated in domestic currency and funded in that currency under article 24, it should possess the discretion to allow in these circumstances the specific interest rate risk capital charge to be zero.

2) The Banking Association is of the opinion that the New Accord should take care of those instances where accounting procedures following the IAS guidelines do not reflect the real risk of the position (e.g. embedded derivatives).

part B – technical comments

1) The Czech National Bank recommends reconsidering the requirement for compulsory use of the more prudent side of bid/offer (article 575) and suggests that the use of the mid rate be also allowed for those banks which are not market makers.

2) Article 576 stipulates requirements for the use of a valuation model where marking to market is not possible. The Czech National Bank raises an objection to the requirement of holding a secure copy of the model (5^{th} indent from the top). The requirement is excessive with respect to the costs and technical problems associated with holding an extra model and, furthermore, it is inconsistent in the sense that it is not extended to other IT systems in banks.

The First Pillar – Operational Risk

Given that the concept has not been finalised, the Czech National Bank does not make any distinction between conceptual and technical comments.

1) The loss types in Annex 4 of the supporting document should be elaborated so that it is mistakable which potential unfavourable events should be taken into account in setting the parameters PE (probability of loss event) and LGE (loss given that event) under the Internal Measurements Approach. Problems occur especially in interpreting the notion "indirect loss".

2) It is necessary to identify the lengths of two periods in the Basic Indicator Approach. Firstly, the period serving as the basis for determining gross income, and secondly, the following period during which the calculated capital requirements remain valid.

3) The guidelines for calculating the parameters PE and LGE in the Internal Measurement should be extended to cover the following situations. Firstly, introduction of new activities, secondly, expansion of existing activities, thirdly, the situation where development of the market gives rise to new products or activities which do not fall within any of the current business lines. In this connection, the Banking Association is concerned about activities such as e-banking, non-stop services, etc. Furthermore, it is necessary to specify how often these parameters will have to be updated. The Czech National Bank is of the opinion that an extra update should be demanded in the event of expanding new activities.

4) Article 563 requires an independent operational risk management and control process. We expect that the standards for operational risk management being prepared by the Basle Committee will elaborate the requirement for independence. Given that operational risk arises from any banking activity, it is necessary to specify which activities go well with operational risk management and which do not.

5) Article 559 (Internal Measurements Approach) requires the setting of a floor in relation to the capital charge, and the supporting document proposes two possible techniques for setting the level of the floor (article 46). The Czech National Bank prefers the former technique, i.e. taking a fixed percentage of the capital charge under the Standardised Approach.

6) The Czech National Bank is of the opinion that banks should be allowed, under specified conditions, to take into account insurance in calculating capital charges.

7) The Czech National Bank is of the opinion that under the Standardised Approach the indicator relating to trade and sales should be the greater of gross income and VAR instead of choosing between the two items (article 553).

8) Under the Internal Measurements Approach it is necessary to specify the lengths of the periods to which the indicators relate.

The First Pillar – Credit Risk – the Internal Ratings Based Approach

The techniques of the internal ratings based approach are beyond the scope of our expertise and it is very difficult to answer the questions in the consultative documents and take standpoints. Our comments concern unique aspects and they are neither conceptual nor technical.

1) One particular Czech bank has a very diversified retail portfolio and little diversified portfolios in the other five classes of assets. From the point of view of this bank, a sound approach would be to apply the internal ratings based method to the retail portfolio and the standardised method to the other classes of assets. The Czech National Bank asks if such an approach is permitted. The Banking Association is of the opinion that there should not be any restrictions to using different methods for different classes of assets.

2) The Banking Association is of the opinion that the current conditions for applying the internal ratings based approach are for several reasons not motivating. Firstly, the values of the BRW_c parameter are set so severely that, using this approach, those banks with clients of other than excellent quality will be at a disadvantage. Secondly, the banks from the emerging markets will not have at their disposal the required historical series of data. Thirdly, the approach will not work in banks with a specific area of business (e.g. banks with a small banking book), regardless of whether these banks are from an advanced market or an emerging market.

The First Pillar – Securitisation

part A – conceptual comments

1) Risk weights of banks, corporations and securitisation tranches should be the same as long as they fall into the same rating category.

2) Articles 13 and 86 of the supporting document lay down requirements for legal opinion. The Banking Association proposes that legal opinion be replaceable, under some circumstances, with an external auditor's opinion. The Czech National Bank does not support this proposal.

3) The treatment of the securitisation issue should be extended to the area of reporting credit exposure.

part B – technical comments

1) There seems to be a discrepancy between the first sentence of article 516 and footnote 40 relating to article 516. The sentence reads "Securitisation involves the legal **or** economic transfer of obligations...." while the footnote says "This section deals with traditional securitisation and does not address synthetic securitisation.". If the transfer is only legal and not economic we deem the situation to be synthetic securitisation, which, according to footnote 40, is not addressed in the consultative document, while the text of the first sentence of article 516, using the conjunction "or", includes this situation.

2) The stipulation of the first paragraph of article 527 allows certain types of ABS to be assigned to the risk category appropriate to the underlying asset. This possibility should be described in more concrete terms, because the underlying assets can form a pool with components of different risk weights.

3) The part of the New Accord devoted to securitization should contain a glossary of definitions in order to make the text comprehensible for the banking community in general. The securitization issue goes beyond the scope of banking activities common in Europe.

The Second Pillar (except the interest rate risk of the banking book)

The Czech National bank, along with the Banking Association, has only one comment in this area. The existing form of the concept is very vague and urgently needs adjustment in the following sense. The algorithm for converting a bank's risk profile into capital charges should be made uniform on the international level. A training seminar should be organised for national regulatory authorities and the national regulatory authorities should agree upon a uniform level of severity, otherwise those banks the national regulator of which takes a more liberal approach will gain a competitive advantage. The risk factors for individual capital add-ons above the overall 8% level should be listed one by one in order to forestall a situation that a bank is charged twice for the same risk, firstly according to Pillar 1, secondly according to Pillar 2. Furthermore, the Banking Association requires that a ceiling (i.e. an upper limit) should be attached to every capital add-on.

Interest Rate Risk of the Banking Book

part A – conceptual comments

1) In order to determine whether the bank's exposure in a given currency is substantial or residual the text uses the following criterion (article 82 of the supporting document, article 6 of Annex 3 of the supporting document). The bank should check whether the currency accounts for 5% or more of its banking book assets. From the point of view of the Czech National Bank this approach is not correct. There might be, for example, a bank with a small volume of banking book assets in a given currency and a large volume of banking book liabilities in that currency; the criterion will mark this exposure as residual, while in reality it is substantial. Therefore the Czech National Bank proposes an alternative criterion that the bank should check whether the currency accounts for 5% or more of its banking book assets or 5% or more of its banking book liabilities. If any of the two conditions is met the given currency should be treated as substantial in the context of the interest rate risk of the banking book. The approach of the Banking Association to this issue is not uniform. On the one hand, the Banking Association recognises the greater correctness of the alternative criterion, on the other hand, it appreciates that the original criterion is simple and technically undemanding.

2) The text does not stipulate clearly whether the interest rate shock should be calculated in each residual currency separately or in the residual currencies in total (article 82 of the supporting document, article 6 of Annex 3 of the supporting document).

3) In order to ensure objectiveness in calculating the interest rate shock, the procedure of setting modified durations in currencies and time bands should be made uniform on the international level. There are two possibilities for the Basle Committee to achieve this objective. Firstly, setting fixed numbers, secondly, setting a methodology and the frequency of updating. In addition, there should be minimum requirements in relation to the number of time bands and their lengths.

part B – technical comments

1) The description of method (a) for exposures in non-G10 currencies should be more precise (article 81 of the supporting document, article 2 of Annex 3 of the supporting document). We interpret the text in the following way. Firstly, the interest rate changes are observed and the 1st and 99th percentiles are chosen. Secondly, a parallel rate shock is calculated – similarly as in the method (a), using the 1st percentile of the observed interest rate changes instead of 200 basis points. Thirdly, the same procedure is applied to the 99th percentile. The Czech National Bank needs to confirm that the real meaning of the text conforms to this interpretation.

2) The description of method (b) should be more precise. We interpret the text in the following way. Firstly, time bands are determined and the longs and shorts in each time band are offset, resulting in a single short or long position in each time band. Secondly, the interest rate changes are observed and the 1st and 99th percentiles are chosen; the vertices of the yield curve at which the interest rates and the interest rate changes are observed are the midpoints of the time bands. Thirdly, the change of the present value of the net position in each time band is calculated in relation to the 1st percentile, producing

an overall profit or loss when the results from the individual time bands are put together. Fourthly, the same is applied to the 99th percentile. The Czech National Bank needs to confirm that the real meaning of the text conforms to this interpretation.

Scope of Application

part A – conceptual comments

1) The Czech National Bank recommends giving up the constraint that the New Accord will be applied to **internationally active banks** and extending the New Accord to all banks. Small and/or specialised banks will proceed according to the least demanding alternatives.

2) The Banking Association is concerned that the New Accord has been developed, explored and tested solely in co-operation with large internationally active banks. It foresees a danger that smaller and/or specialised banks will be capitally penalised for the inaccessibility of more sophisticated methodologies rather than for the real size of the risk undertaken.

part B – technical comments

1) In the case of subsidiaries and significant minority-owned investments it is necessary to make more precise the deductions of 50% from Tier 1 and 50% from Tier 2 according to article 18. Specifically, as the size of Tier 1 limits the size of Tier 2 it must be explicit whether the limiting factor is Tier 1 before deducting 50% from it or Tier 1 after deducting 50% from it.

The Third Pillar – Market Discipline

In relation to this area the Czech National Bank has conceptual comments only

1) The requirements laid down in the first paragraph of article 668 (interest rate risk in the banking book – qualitative disclosures – core disclosure) should be extended to the other categories of market risk, i.e. they should be included among the core disclosure requirements in article 663.

2) The Basle Committee should take a standpoint in this crucial issue. Should the information about the capital ratio set individually by the regulator (the "trigger ratio") be included among the obligatory disclosures?