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Basel Committee on Banking Supervision
Basel Committee Secretariat
Bank for International Settlements
CH-40001 Basel

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The New Basel Capital Accord

Comments of the Danish Financial Supervisory Authority on the Second Consultative Document on the New Basel Capital Accord

On the 16 January 2001, the Basel Committee on Banking Supervision released the Consultative Document on The New Capital Accord.

Based on this document the European Commission issued a consultative document entitled "Commission Services' Second Consultative Document on Review of Regulatory Capital for Credit Institutions and Investment Firms".

In Denmark, the consultative documents from the Basel Committee and the European Commission were addressed by a working group comprising members from the Ministry of Economic Affairs, including the Danish Financial Supervisory Authority, Danmarks Nationalbank, the Danish Bankers' Association, and the Association of Danish Mortgage Banks. In addition to this, the Ministry of Economic Affairs has submitted the document from the European Commission for consultation with other parties, which may be affected by the proposals.

This paper presents the comments made on this background on the European Commission's consultative document. We consider that they also have relevance for the Consultative Document to The New Capital Accord from the Basel Committee, on which the European Commission's document largely relies.

<u>General Remarks</u>
Two of the main objectives behind the current Basel Capital Accord are, firstly to ensure that the own funds of the relevant institutions correspond to the risks, and secondly to ensure a level playing field for these institutions. The Own Funds Directive and the Solvency Directive had the same main objectives. Denmark finds that it is important to maintain these main objectives in the forthcoming directive.

Denmark supports the overall structure of the document with its three pillars; Minimum Capital Requirements, Supervisory Review Process, and Market Discipline.

Denmark agrees with the Commission that it is important to be aware that these regulations must also apply to small and medium-sized financial institutions. Thus, the regulations must be formulated in a manner which ensures that the regulatory capital requirements also correspond with the risks found in such small and medium-sized institutions.

Denmark agrees that the capital requirements should, as far as possible, reflect the financial risk. It is, however, also necessary to ensure that the rules do not become so detailed that they become too costly and administratively cumbersome for the institutions. If simple rules entail higher capital requirements than more detailed ones, it must be possible to demonstrate that the detailed rules provide a more accurate assessment of the risk.

Denmark considers that the treatment of credit-risk mitigation is too detailed and too administratively cumbersome for institutions. This also means that the institutions are unlikely to be able to apply these rules in their internal risk management.

A number of Danish banks, mortgage banks, and investment firms have sought to calculate the effects of the regulations proposed. These calculations show that there is considerable uncertainty as to how these proposals are to be understood, and that much is left to the assessment and discretion of individual institutions and the supervisory authorities in each country. These uncertainties and elements of assessment and discretion mean that two institutions with identical risks may well arrive at very different capital charges.

Internal Rating

Uncertainty regarding calculation of the capital charge is especially pronounced in connection with the regulations on the internal rating approach, and the proposal features very prominent elements of assessment and discretion. The following aspects should be pointed out:

1. How is “default” defined? The Danish institutions which have carried out calculations of the effects have tried to follow the guidelines provided in the proposal, but have arrived at very different definitions. It must be assumed that the differences between individual countries would be even larger, partly due to differences in accounting regulations and supervisory practises.

2. To what extent should “point in time” or “through the cycle” be taken as the point of departure in risk assessment, and to what extent should account be taken of changes over time in the institution’s credit policies, credit management, and loan portfolio?

   These issues are very important. In Denmark, for example, institutions experienced large losses and loss provisions in the early 1990s, followed by a longer period of low losses and provisions.

If the capital charge is based on “point in time” assessments, such capital charges will be low during upturns of the economic cycle and increase greatly during periods of recession. This would be inexpedient.

3. What requirements are levelled against institutions as regards documentation that the statistical basis used in rating is adequate? The requirements are unclear, but seem much more limited in scope than the requirements applying to internal models on market risks in the CAD II Directive. This does not tie in well with the fact that for most institutions, credit risks are more important than market risks. If the requirements are not clear enough, there will be a risk that this could become a competition parameter.

Denmark considers that there is a great need for a reduction in the uncertainties and elements of assessment and discretion in connection with the application of the internal rating approach. This includes the need to ensure that “default” is defined in the same way in the individual countries. When this has been carried out, new calculations of the effects of this proposal should be carried out.

Denmark also considers that it is important that the internal rating approach is drafted in a way which ensures that the regulatory minimum capital requirements are not too procyclic.

In order to secure the intentions of the changes in the capital requirements, it is important that the rules on internal rating are designed so that a large proportion of institutions can apply the methods. In order to provide a greater incentive to institutions which want to apply internal methods, they should be granted a transitional period. This should apply irrespective of when institutions start applying internal rating.

<u>External Rating</u>
Denmark believes that there should be closer examination of whether it is appropriate that low-rated counterparts are weighted by 150 per cent, while unrated counterparts are weighted by 100 per cent.

<u>Operational Risk</u>
The proposals on operational risks are also at a very preliminary stage, and the effects they may have are therefore difficult to calculate at present. Nonetheless, Danish banks, mortgage banks, and investment firms have tried to prepare calculations of the effect of these proposals. These calculations seem to show that the proposals put forward, which are based on the conditions prevalent within major, internationally active banks, require substantial adjustments in order to be usable by, for example, local institutions. In particular, investment firms can be heavily impacted by the proposed regulation.

Denmark supports the intention of making the standardised approach accessible to as many institutions as possible, and that this approach could take into account certain measures to mitigate risk. This should not, however, entail that no further work is carried out to develop the basic indicator approach, including work to ensure that this approach would also be able to take into account certain risk-mitigation measures.

Interest-rate Risks

Denmark disagrees with the proposals on treatment of interest-rate risks in the banking book. Denmark is of the opinion that the practise of making a distinction between interest-rate risks in the trading book and the banking book should cease. Maintaining such a distinction will continue to involve undesired arbitrage. At the same time, the capital change on all interest-rate risks must be calculated on the basis of those methods which are already being used in the CAD Directive.

The Basel Committee proposes to move the interest-rate risk of items in the banking book to the second pillar (the Supervisory Review Process). The reason provided by the Basel Committee for this is that significant differences exist between internationally active banks as regards the nature of the underlying risk and the banks' management thereof.

Denmark is of the opinion that such risks should be managed in accordance with the principles applying to interest-rate risks in the trading book. Also, it can be assumed that considerably larger differences exist between the credit risks and - especially - operational risks of various institutions and the management of such risks. This fact has not led the Committee to propose that these types of risk be moved to the second pillar.

Supervisory Review Process

Generally speaking, Denmark supports the philosophy behind the Basel Committee's proposal regarding the Supervisory Review Process. However, this philosophy should take a much more precise form before it can be implemented at European level. As a point of departure, Denmark also supports the flexible approach proposed by the Commission. This proposal is, however, very general in nature as yet, and Denmark will only be able to offer final support when a proposal on how this framework is to be filled in becomes available. In this connection, it is important that steps are taken under the Supervisory Review Process to ensure that only those risks which are not already adequately covered by minimum capital requirements under pillar one can result in higher regulatory capital requirements applied to an institution.

The individually applied regulatory capital requirements are to contribute to ensuring that the institutions do not compromise the interests of individual depositors by taking on risks which, due to errors and/or omissions in the regulations, are inadequately covered within the standard minimum capital requirements under pillar one.

Denmark considers that in particular, steps must be taken to ensure that the allocation of individually applied regulatory capital requirements is carried out in an administratively and legally appropriate manner. In addition to this, steps must be taken to ensure a certain degree of consistency in the various countries' allocation of individual capital requirements in order to ensure a level playing field within the EU.

Denmark also considers that the Directive should specify that the competent authorities must react in the same manner to institutions which do not comply with their individually applied regulatory capital requirements as they do to those institutions which do not comply with the minimum capital charge of 8%.

Market Discipline

Denmark supports the proposal put forward by the Commission on requiring that institutions disclose a number of key accounting figures which form the basis for their individually applied regulatory capital requirements. Denmark also agrees that the preparation of rules for disclosure of such figures should be carried out in connection with a general revision of IAS 30.

Denmark disagrees with the Commission's assessment of the relationship between advantages and disadvantages as regards the disclosure of individually applied capital requirements and considers that such capital requirements should be disclosed.

In addition to the disciplining effect of a disclosure of individually applied capital requirements, Denmark considers that withholding information which must be expected to have significant influence on the price of securities issued by an institution would run counter to the principles regarding transparency in the securities markets.

If specific, seriously detrimental effects can be identified, the competent authorities may grant exemptions from the requirement regarding disclosure if they consider that such omission would not be likely to mislead the public with regard to facts and circumstances, knowledge of which is essential for the assessment of the shares in question. This authority is laid down in Table C, point 5a of the Directive 79/279/EEC, Article 9 (4) of Directive 82/121/EEC and Article 7 b of Directive 80/390/EEC.

Denmark does not share the Commission's fear that investors will act on information regarding individual regulatory capital requirements to any greater extent than they will on other available information.