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Danmarks Nationalbank comments on the January 2001 Consultative Document "The New Basel Capital Accord"

Danmarks Nationalbank welcomes the opportunity to respond to the Committee's proposal. Danmarks Nationalbank supports the general objectives stated in the Basel Committee's proposal and is in agreement with the general thrust of the proposed three-pillar approach.

1. The first pillar: Minimum capital requirements

Danmarks Nationalbank supports the introduction of a menu of approaches providing banks incentives to improve their internal control and risk management systems.

Credit risk

Standardised approach

Danmarks Nationalbank welcomes that the standardised approach has been made more risk sensitive compared to the June 1999 proposals. However, as the number of externally rated companies in Denmark is very limited, the recognition of external ratings in general is less useful. It is therefore crucial that level-playing field is ensured in the recognition of external and internal rating systems.

It is proposed that national supervisory authorities are responsible for the recognition of external assessment institutions based on a set of criteria. It is important that this process is transparent and ensures consistency in order to secure level playing field.

Internal ratings-based approach

The internal ratings-based (IRB) approach should be framed in a way that could potentially be applied by all banks, not just large or sophisticated banks. The development of an evolutionary approach to internal ratings to a certain extent meets this concern. However, in order to ensure level playing field and financial stability we would recommend that further efforts be

made to make the requirements for the use of the internal ratings-based approach more clear.

The use of the internal ratings-based approach may significantly increase the risk of pro-cyclical effects in capital requirements. It is therefore important that banks' evaluation of capital adequacy is forward-looking and takes into account the effect from a full economic cycle so that appropriate capital buffers are in place to absorb cyclical risks.

As the range of risk weights is significantly wider in the IRB approach compared to the standardised approach there is a risk that only banks with low-risk borrowers apply the IRB method while banks with high-risk borrowers maintain the standardised approach. Thus, accuracy and consistency with the revised standardised approach should be ensured.

The proposal that a bank using the IRB approach for some of its exposures is required to adopt the IRB approach across all of its exposures within a reasonable short period of time seems inappropriate. For smaller banks that may have one or more exposure classes for which they have developed an IRB approach, the cost of developing an IRB approach for the remaining exposures might be very high in relative terms. Therefore, if the remaining exposures are not material, it should be possible to exempt them from the IRB approach. Furthermore, it may not be relevant for smaller banks to develop internal ratings on exposures such as other banks or sovereigns, but instead use external ratings. However, in general it is important that cherry-picking opportunities are prevented in the adoption of the IRB approach.

Operational risk

In general, attention should be paid to the impact of the capital charge for operational risk on different categories of institutions, especially to smaller banks that are unlikely to benefit from a reduction in their capital charge for credit risk in the new framework.

It is important that the capital charge for operational risk contains incentives to better control this type of risk. Regarding the Standardised Approach the calibration of the beta-values should take differences in operational risk features into account. Business lines where the main risk features have already been covered by capital charges on credit or market risk should be given smaller beta factors.

2. The second pillar: The Supervisory Review Process

With the introduction of the second pillar, the role of supervisors is enhanced markedly. The supervisory review process is based on the assumption that supervisory authorities to a larger extent take qualitative factors into account.

If individual minimum capital requirements above the 8% minimum are introduced, Danmarks Nationalbank is of the opinion that these should be based on clear objective criteria. This is important in a legal context as well as in order to ensure a level playing field.

Danmarks Nationalbank believes that the decision to treat interest rate risk in the banking book under Pillar 2 instead of under pillar 1 is inappropriate. Danmarks Nationalbank believes that capital charges for interest rate risks should cover both the trading book and the banking book, e.g. on an integral basis.

A lack of appreciation of cyclical risks and the possible point-in-time status of banks' internal risk control systems rise the concern of the pro-cyclical nature of the capital regulation. Therefore supervisory authorities should pay attention to the adequate stability and conservatism of banks' internal ratings and should be given the possibility to use methods that ensure cyclical stability.

3. The third pillar: Market Discipline

Danmarks Nationalbank supports an increasing role for market discipline and believes that increased transparency will contribute to soundness in the financial system and enhance financial stability. However, it is important that the same rules apply to all banks in order to safeguard equality in terms of international competition. This will furthermore contribute to transparency concerning convergence in supervisory practices.