Our Ref : G12/55/5C
CB/POL/4/5/2

28 May 2001

Madame Danièle Nouy
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002
Basel
Switzerland

Dear Danièle,

<u>Comments on the Second Consultative Package of the New Basel Capital Accord by EMEAP Working Group on Banking Supervision</u>

I am writing to provide you with the general views and comments of the EMEAP Working Group on Banking Supervision[1] on the latest capital proposals issued by the Basel Committee in January this year. They are based on members' discussion of the New Accord at a meeting held in Seoul on 20 April 2001. We would also like to thank Ms Zahra El-Mekkawy for attending the meeting and providing a very useful update on the current developments in the New Accord.

Overall, members of the Working Group expressed general support for the more risk-sensitive approach to the measurement of capital requirements proposed in the New Accord. Various concerns were however raised in

[1] The economies represented on the EMEAP Working Group are Australia, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, and Thailand.

relation to specific aspects of the New Accord and issues associated with implementing the proposals, the key points of which are summarised below. Due to shortage of time, our discussion mainly focused on Pillar 1.

General Comments

1. Given the complexity of the New Accord, implementing the proposals will have significant resource implications for national supervisors. For example, there will be a lot of work associated with amending banking legislation, developing relevant supervisory policies and guidelines and devising new banking returns. Rather than each individual national supervisor duplicating such work on its own, it would be helpful if the process could be centralised to some extent (e.g. through the development of "model" guidelines and legislation). Of course, any such models would need to be adapted by local supervisors to suit the particular circumstances of their own jurisdictions. This suggestion could perhaps form part of the work of the "college" of supervisors which we understand the Basel Committee is to set up to provide a forum to exchange views on the implementation process.

2. Even the standardised approach of the New Accord may be too complicated and costly for some smaller banks. Some members of the Group therefore support the initiative to develop a simplified version of the standardised approach for such banks (although this should not preclude local supervisors from exploring other options).

3. While the Basel Committee has stated explicitly that the intention is to maintain the overall level of capital in the banking system, the proposals are unlikely to achieve this for Asian banks in general. It is expected that the new charge for operational risk will more than offset any reduction in capital under the standardised approach. The effect will be further aggravated by the limited recognition of collateral under credit risk mitigation (see points 12 to 14 below). Any resultant increase in capital requirements would potentially disadvantage Asian banks and could impose strain on economies which are still recovering from the Asian crisis.

4. There is some concern about how market participants will interpret the relative capital strength of banks using different approaches under the New Accord. A particular issue is that under the internal ratings-based (IRB) approach, the capital adequacy ratio may be subject to greater fluctuations over the economic cycle, which may

be open to misinterpretation. This will require efforts by both the Basel Committee and national supervisors to educate the market about the impact of the New Accord.

Scope of Application and Timetable

5. Applying the New Accord to international banking groups on a consolidated basis across different jurisdictions could result in some difficult implementation issues. In particular, if host and home supervisors exercise national discretion as to the various options in the Accord in different ways, banks could be faced with the need for multiple layers of reporting on different bases. In addition, discretion exercised by each national supervisor may not be consistent or based on the same standard. To address this cross-border issue, the Basel Committee is requested to provide clear guidance to home and host supervisors on their respective responsibilities in applying consolidation to an international banking group and on the need to harmonise, so far as possible, their approaches to the New Accord. The Basel Committee may also wish to encourage supervisors to disclose how they would exercise national discretion under the Accord.

6. One particular aspect of this problem, which a number of the regulators in the Region may face, is that international banks with subsidiaries in their jurisdictions may wish to apply the IRB approach to such subsidiaries. However, the host supervisors may have neither the resources nor the inclination to apply the IRB approach in their territories. This raises the question as to how the IRB approach of the subsidiaries is to be validated. If this is to be done by the home supervisor, it raises the further question as to whether the host supervisor can cede such a responsibility to a bank situated in its jurisdiction for which it has direct supervisory responsibility. Another point raised by some members is whether the host supervisor can rely on third party experts employed by banks to validate their internal rating systems.

7. Implementing the New Accord will require extensive work by national supervisors and banks in the period leading up to 2004. The implementation schedule is particularly tight for banks which have complex global operations and are seeking to adopt the IRB approach in 2004.

Standardised Approach

8. Many, if not most, banks in the Region are likely to adopt the standardised approach. Though banks that have the capability may be encouraged to move towards the IRB approach in due course, it is important to avoid any market misconception that banks using the IRB approach are superior to those adopting the standardised approach. It is also important not to encourage the belief among banks and their regulators that the IRB approach should be adopted for "prestige" reasons without the necessary infrastructure to support it. We consider that the Basel Committee should state clearly in the New Accord that the standardised approach is a sufficient and reasonable approach for banks to use, and should not be perceived as a "second-rate" approach.

9. The Committee is requested to clarify the treatment of domestic currency ratings. It appears (paragraph 11 of the supporting document) that they can be used for domestic currency obligations of sovereigns. Does this also apply to domestic currency obligations of non-sovereign entities (including corporates)? This would appear to be a reasonable approach.

10. Regulatory arbitrage may result from having a choice of two possible options for claims on banks. While Option 2 appears to be a more appropriate option as it relates capital to the individual ratings of banks, the choice of Option 1 could enable financially weaker banks to leverage on the stronger rating of their sovereign. Some members noted nonetheless that Option 1 might help to maintain the stability of interbank markets.

11. Supervisors are required to determine the list of recognised external credit assessment institutions and slot their ratings into the standardised risk-weighting framework. This could be a problem for supervisors that have not built up sufficient expertise in these areas.

12. Under the new proposals, the risk weight of residential mortgages will rise sharply from 50% to 150% once they are past due for more than 90 days. It appears that no allowance is to be given for the fact that the loans are secured by residential properties. This effectively equates the default risk of residential mortgages with that of unsecured corporate loans when both types of loans become past due for more than 90 days and is not consistent with the low risk nature of residential mortgages. Moreover, the risk weight of 50% for

residential mortgages is already quite conservative compared with that implied under the IRB approach. This reinforces the view that the 150% risk weight would be excessive.

Credit Risk Mitigation

13. It is not proposed that real estate collateral, though a common form of collateral for many banks in the Region, should be recognised for the purpose of credit risk mitigation under the standardised approach. While such collateral is subject to fluctuations in market value and is usually less liquid than financial collateral, it is more appropriate to deal with these issues through applying appropriate "haircuts" than by disregarding the value of the collateral entirely.

14. Where objective standards regarding enforceability and valuation can be satisfied, we consider that real estate should be accepted as eligible collateral subject to appropriate "haircuts". Similarly, the value of real estate collateral should be recognised for the calculation of past due assets under the standardised approach. Broader recognition of collateral would in general help to mitigate the impact of the likely net increase in capital requirements due to operational risk.

IRB Approach

15. Banks that intend to implement the IRB approach in 2004 will only be required to have a minimum data period of two years. There is concern that this short data period will not be enough to capture the default data during a full credit cycle and will impose difficulties for supervisors to validate banks' estimates of probability of default (PD). Supervisors might therefore need to require banks to use higher PDs if their own estimates are considered to be too low for the calculation of capital charges. The Basel Committee is requested to provide guidance to supervisors on the methodology for validating use of the IRB approach during the transition period.

16. As a bank may wish to use external (e.g. agency grades), internal, or pooled data sources, or a combination of the three for estimation of PD, the Basel Committee is requested to provide further guidance to supervisors on the specific requirements for the use of such data sources (e.g. mapping of internal ratings to agency ratings).

17. Some banks have expressed doubt as to whether there are sufficient incentives in the present calibration of the Accord to justify adoption of the IRB approach. In particular, it has been suggested that for banks with a significant exposure to SME (i.e. small and medium enterprises) customers, the IRB approach would result in a higher capital requirement than the standardised approach. It appears that, when calibrating the foundation approach, insufficient cognizance has been given to the way that banks manage their SME business, for example, by lending on shorter tenors or enforcing stricter covenants.

18. We understand that the IRB approach has been calibrated to cover both expected and unexpected losses. This may confuse the issues of capital adequacy and provisioning. It may be necessary for the Basel Committee to further clarify the functions of capital and provisions so as to avoid any double counting of expected losses.

<u>Operational Risk</u>

19. As the business activities conducted by most banks in the Region are conventional in nature, such as retail banking and commercial lending, their operations are less complex than those engaged in by large international banks. In view of this, the allocation of a 20% capital charge for operational risk is considered to be too high for these banks. In the case of Hong Kong, for example, the basic indicator approach (which is the only one where a capital factor is presently provided) would reduce the capital adequacy ratio of banks by an average of 300 basis points. This seems excessive and not in line with the actual operational losses experienced by banks.

20. As mentioned earlier, it is unlikely that the new capital charge for operational risk will be offset by savings in the capital charge for credit risk under the standardised approach for banks in the Region. As a result, their overall capital requirements will increase. It is considered necessary for the Basel Committee to reconsider the benchmarks used for operational risk based on the extended Quantitative Impact Study currently being undertaken.

21. The internal measurement approach seems to be too complicated for adoption by most banks in the Region, at least initially. Regarding the standardised approach, some members considered that the use of annual average assets as the indicator for the business lines of retail banking and commercial banking could result in double counting in terms of credit risk captured under Pillar 1. The Basel Committee

may wish to consider using other more appropriate indicators to measure the operational risk of these two business lines.

I hope that the Basel Committee will consider these comments and address the concerns of banking supervisors in this Region. Please let me know if any clarification is required.

Yours sincerely,

D T R Carse
Chairman,
EMEAP Working Group on Banking Supervision