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The Basel Committee on Banking Supervision,
Bank for International Settlements
CH-4002 Basel
Switzerland

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To the Basel Committee Secretariat,

FITCH'S RESPONSE TO THE REVISED BASEL CAPITAL ACCORD PROPOSALS

Following publication by the Basel Committee on Banking Supervision of the consultation document, The New Basle Capital Accord, in January 2001, I attach Fitch's detailed response to the proposed Accord.

You will see that, for the sake of simplicity, our comments follow the same structure as the consultation document. Although they focus mainly on suggested recommendations, our overall reaction to the proposed Accord is positive. Clearly, as already stated by the Committee and other interested parties, by strengthening the relationship between economic and regulatory capital, the proposed Accord should improve risk management standards and, therefore, promote greater financial stability.

Please note that, although the comments on asset securitisation are limited, Fitch is participating with the Committee's working party on securitisation and will provide further feedback through this channel.

If you wish to discuss any of the points raised in this letter, please do not hesitate to contact me on 00 44 207 417 4315.

Yours sincerely

Robin Monro-Davies
Chief Executive Officer

SCOPE OF APPLICATION

1. Having frequently pointed out the excessive market risk to which certain banking systems are exposed, we strongly favour the new rules concerning the deduction of sizeable equity stakes in commercial entities from a bank's capital, although it is not clear how this regime will work in practice. Also, the 15%/60% cut off points for deduction are too generous. As an alternative, we suggest 10%/50%, which would be more prudent.

THE FIRST PILLAR – MINIMUM CAPITAL REQUIREMENTS

THE STANDARDISED APPROACH

1. While the 'Standardised Approach' is a welcome improvement over the 1988 Accord, it uses ratings in a way that is fundamentally against their nature. Specifically, the notion that a equivalently rated sovereign is a better credit risk than a bank, which is in turn less risky than a corporate, is false. A 'BBB' rated counterparty has the same risk profile, whether it be a sovereign, bank or corporate.

2. Option 1 for weighting bank exposure makes no intellectual sense. Therefore, we strongly recommend that the Committee adopt Option 2 for assigning risk weights to banks, although as pointed out in point 1, our optimal approach would be for all entities rated the same to be assigned the same risk-weighting.

3. The treatment of unrated entities is too generous, especially vis-à-vis low-rated counterparties. This is particularly true for banks under Option 2, where unrated institutions are weighted the same as investment grade entities rated 'A+' to 'BBB-', and for claims with a maturity of three months or less, where unrated banks receive a treatment 7.5 times more favourable than banks rated below 'B-'. Obviously, this will act as an incentive for an entity not to seek a rating and, therefore, impinge upon the development of financial transparency. We suggest that the overall hierarchy of risk weightings within a counterparty type should be AAA to AA-, A+ to A-, BBB+ to BBB-, BB+ to BB-, B+ to B-, Below B- and unrated, and finally non-performing assets. For example, the weighting of unrated corporate entities should be raised from 100% to 150%, i.e. the same as entities rated below 'B-'.

4. Despite the rigorous qualification of the exceptional weighting of commercial real estate lending at 50%, such exposures should, in our opinion, almost always be weighted at 100%, reflecting the sector's role in previous banking crises as well as the lag between a deteriorating loan book and increased capital requirements.

5. The creation of a 150% weighting 'bucket' is a useful supervisory tool, particularly for the treatment of unsecured, net non-performing loans.

6. However, assigning 'B+' to 'B-' rated corporates to the 150% 'bucket' will impair the development of the high-yield market. Also, their treatment looks harsh, given that the average 'B' rated credit has a much better risk profile than a non-performing asset. We suggest, therefore,

that non-performing loans are weighted at 200%, an approach consistent with the hierarchy proposed in point 3.

7. We welcome the proposed Accord's intention to prevent 'cherry-picking' of ratings, a process that would undermine the whole standardised approach. Also, the method for using multiple assessments by external rating agencies seems fair.

8. The intention to weight bonds and other obligations according to their issue rating is welcome as capital held against positions in subordinated and preferred issues will more accurately reflect the risk of such instruments.

9. The proposal that subsidiaries within groups should not necessarily be treated the same from a rating and, therefore, weighting perspective is a recognition of the legal, currency and support risks that exist within groups.

CREDIT RISK MITIGATION IN THE STANDARDISED APPROACH

1. The wider recognition of collateral and the use of on-balance sheet netting and guarantee agreements is to be welcomed as increased use of credit mitigation techniques can only reduce bank exposure to credit risk and improve risk management practices.

2. However, in certain banking systems, other sources of collateral play a significant part in credit risk mitigation, for example, accounts receivable and inventory in the USA. Discretion, therefore, should be granted to local regulators to widen the definition of collateral to reflect the characteristics of different banking and legal systems.

3. The recognition of the hedging benefits of credit derivatives is a positive step as such instruments are an effective and established risk mitigation tool. The use of a mandatory floor, however, seems counterproductive to the market's development and inconsistent vis-a-vis treatment of guarantees. Specifically, guarantees can be viewed as functional equivalents and competing products to credit derivatives, yet guarantees are not subject to a floor factor. This will likely hinder the further integration of credit derivatives as part of a robust risk management framework. Also, an arbitrary floor factor seems difficult to justify since contract non-performance is a binary event -- either the contract performs as intended or it doesn't -- and to date most counterparties on the whole have fulfilled their obligations as anticipated. As a final point, it could be argued that any so-called operational or non-performance risk that is present in credit derivatives, guarantees or any other contract is adequately captured in the operational risk measures as proposed by the Committee and, therefore, a floor factor is duplicative.

THE INTERNAL RATINGS BASED APPROACH

1. The development of sophisticated internal rating models that allow banks to achieve a greater understanding of their exposure to credit risk and enhance their ability to manage that risk is clearly a positive move. However, at the moment, significant problems remain, such as a lack of comprehensive and reliable default and recovery data, as well as inadequate back-testing

results and insufficient regulatory emphasis on such results. The Committee's intention, therefore, to

introduce a 'foundation' and 'advanced' approach to credit rating models, coupled with comprehensive disclosure requirements is to be welcomed.

2. Given these concerns and that banks using the 'advanced' approach will have significant discretionary powers, we believe that disclosure requirements and aggressive, but impartial, supervision have a critical role to play in such IRB models if a level playing field in capital adequacy requirements is to be maintained.

3. In this respect, it is disappointing to note that there is no additional explicit capital charge for the results of back-testing, as there is for models for market risk, although back-testing is captured in the supervisory and model review process.

4. Clearly the efficiency of models is a function of the quality of data input, and the lack of sufficient, reliable information is an industry-wide issue. It is not clear to us why regulators, even though they have obtained their data from the industry, should be considered a more accurate and reliable judge of LGD and EAD rates than the banks or rating agencies, since very few of them have built up comprehensive databases of this type, unless the objective is to ensure a minimum level of conservatism.

5. The proposed Accord's requirement that internal ratings and recovery rates be priced into the cost of credit makes obvious business and prudential sense. This though may not always be possible due to strategic or market considerations.

6. Similarly, the explicit 'linkage' of internal ratings to a bank's provisioning policy is also welcome. However, we would like to see this relationship strengthened, especially for those banks employing the 'advanced' approach. (Some institutions have already adopted statistics-based provisioning policies for internal management purposes, although these have not yet been endorsed for reporting purposes due to regulatory and taxation concerns.)

7. The treatment of the retail book is clearly still in development and requires further work, although the underlying proposals, including the comprehensive breakdown of portfolios into minimum segments with their own PDs and LGDs makes intuitive sense.

8. The granularity adjustment is a good idea as concentration risk can be a big issue for some banks. However, it is not clear to us why a similar adjustment is not used in the standardised approach.

9. In addition, as well as concentration risk by size, of equal importance for some institutions, is concentration risk by industry sector. A 'sector adjustment' factor, therefore, along similar analytical lines to the granularity adjustment would make prudential sense.

10. Also, many banks are building diversification risk into their own credit and economic capital models. Adopting a standardised granularity adjustment means there is a danger that this work will be marginalised. However, portfolio models, which by definition capture concentration and correlation risks, are obviously being looked at by the Committee.

ASSET SECURITISATION

1. The proposed Accord recognises that, although banks may use securitisation as a method of moving assets off balance sheet and, therefore, achieving capital relief, in reality these assets will often still be supported by the bank because of reputational concerns. This market reality has long been recognised by Fitch: we continue to add back on-balance sheet securitised assets for capital analysis purposes. Therefore, the severe penalties the Accord is proposing for banks that support their securitisation structures should add welcome discipline to the securitisation process, although supervisors should have the ability to exercise discretion, for example, when an issue has been supported due to operational or legal problems with the original structure.

2. However, it is not clear to us how a capital charge to cover such reputational and other residual risks in securitisation structures would work in practice given that the incentive to support varies significantly from institution to institution and depends upon such factors as the motive for securitisation and the materiality of securitisation in the context of a bank's overall operations.

OPERATIONAL RISK

1. The attempt to measure operational risks is in itself laudable, but it is debatable how accurate any such measurements can be. Perhaps it would have been better addressed in a separate accord as in the case of market risk, rather than clouding the debate on credit risk.

2. However, given that operational risk is addressed by the proposed Accord, Fitch believes that banks should employ the standardised approach at a minimum.

3. The definition of operational risk excludes reputational risk. However, in our view, this is a major source of risk for some institutions and should be addressed either in the operational risk regime or separately.

4. The proposed system of alpha, beta and gamma factors will in effect give regulators complete freedom when setting operational risk requirements. As a result, the potential for inconsistencies is substantial. Transparency and disclosure between supervisors and the market are, therefore, highly desirable, if not essential.

TRADING BOOK ISSUES

1. For government paper (previously weighted at 0% for most countries), the Accord is proposing combining the 'qualifying securities' scale with ratings, which will increase the charge substantially, especially in the case of emerging markets. This change makes prudential sense.

THE SECOND PILLAR – SUPERVISORY REVIEW PROCESS

1. In effect, the supervisory review process acts as a 'catch-all' for all risks not addressed by formal regulatory requirements. As such, we see it is an important regulatory tool giving supervisors discretion to directly or indirectly increase the capital burden of more risky financial institutions.

2. The required description of banks' assessment of their capital needs and of their capital adequacy and the ensuing minimum standards of supervisory review are both logical and responsible, being based on common sense.

3. The burden upon and the discretion granted to regulators will increase substantially under the new Accord. This may result in inconsistencies between regulators and, therefore, banking systems, which may undermine the proposed Accord's level playing field objective. In this respect, improved transparency from all counterparties is critical.

4. The proposal that supervisors should have the ability to set capital requirements above minimum levels is a long overdue addition to their armoury, especially in those countries with an excessively legalistic approach to banking supervision. Clearly one set of target regulatory capital ratios for all financial institutions does not make sense, something already recognised by many regulators.

5. In addition, this added flexibility may avoid individual national regulators utilising extra capital ratios and thereby undermining the 'level playing field' objective of the proposed Accord, as the US regulators did, for example, with the additional 'leverage' ratio.

6. Pillar 1 of the proposed Accord fails to address the issue of interest rate risk in the banking book, which is a significant source of risk for some banks. Although this will be monitored by the regulatory authorities under Pillar 2 and a system of standardised disclosure is proposed, we consider that this risk should be covered by the appropriate capital charge and thus hope that this shortcoming will be addressed in due course.

THE THIRD PILLAR – MARKET DISCIPLINE

1. The ‘overarching principle’ on disclosure, whilst welcome, is vague. If it is interpreted literally, most banks are already compliant even though their public disclosure may be poor.

2. The division of information between core and supplementary, while necessary to ensure minimum standards, could be used by some banks as an excuse to disclose less.

3. The definition of ‘materiality’ is critical, but unfortunately open to abuse. However, it has to be admitted that there is a lack of practical alternatives.

4. Quarterly reporting should be encouraged as a standard requirement for all banks and not just for data subject to rapid change.

5. A standardised information template is welcome, as it will help reduce banks’ discretion and, therefore, aid the promotion of cross-border comparability and transparency.

6. A full breakdown of regulatory capital is welcome and will help focus attention on the quality as well as the quantity of Tier 1. However, the use of property revaluation reserves and plain vanilla preference shares has not been singled out for disclosure.

7. Disclosure of country exposure as a core requirement is to be welcomed and should improve global transparency, as should information on non-performing assets and provisions. Similarly, information on industry exposures is also welcome. However, the Committee needs to define precisely what it means by ‘exposure’ given the different definitions employed by different regulators and banks.

8. Supplementary disclosure on securitisation and the role of credit derivatives should be a core requirement, although the latter is when using credit mitigation techniques.

9. Disclosure requirements for banks using the IRB approach are suitably comprehensive. Of particular interest are those relating to the back-testing or validation of models, which will help identify those institutions with less robust systems.

10. Enhanced market risk data is welcome. However, it is not clear whether the proposed Accord is asking for the disclosure of regulatory VAR model multipliers, although this would be useful, as would the distribution of daily P&Ls and an explanation of ‘outliers’ in back-testing (currently, only proposed as supplementary information).

11. Disclosure of operational risk exposure by business line and overall charge is clearly necessary if the new operational risk regime is to have any analytical weight.