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Comments from the Financial Supervisory Authority in Iceland (FME)

The Financial Supervisory Authority in Iceland (FME) has reviewed the consultative document, The New Basel Capital Accord (the New Accord), from the Basel Committee on Banking Supervision (the Committee).

The focus of the New Accord is primarily on internationally active banks. There are no internationally active banks in Iceland but the Committee has stated that the New Accord's underlying principles are intended to be suitable for application to banks of varying levels of complexity and sophistication.

In this note, the FME presents its views on the approaches proposed by the Committee. In drafting the note, the FME consulted with the Ministry of Commerce and the Central Bank of Iceland.

1.0 Summary

The FME wants to emphasize the importance that the new framework should suit small as well as large financial institutions. Also, the FME welcomes the proposals to extend the revised Accord to include on a fully consolidated basis holding companies that are parents of banking groups.

The FME has reservations about using external ratings assigned by international credit rating agencies in assessing regulatory capital requirements. The external credit rating agencies may not have access to all relevant information. Their ratings have at times proved to be erratic and subject to sudden changes, e.g. in the East Asia in 1998. Last but not least, external ratings are virtually non-existent in Iceland. Regarding sovereigns, there seems to be little justification for drawing a line between the AA category and the A category as the Committee does. It should be lower, such as at the bottom of the A category. Regarding banks, the FME favours option one, i.e. basing the credit risk weighting for banks on the risk weighting of the sovereign of incorporation, but in one category less favourable. Icelandic banks are small in comparison to other banks and their operation is mainly domestic. The FME fears that financially sound Icelandic banks will never get a risk weighting of AAA to AA- and therefore be excluded from the 20% risk category.

The FME welcomes the idea of an evolutionary IRB approach because it will require banks to develop and enhance their existing risk management systems. The FME wants to emphasise the important role of supervisory authorities in approving internal rating systems of financial institutions and how important it is to ensure comparability of supervisory methods between banks and countries.

The FME is aware of the difficulties to determine the alpha and beta factors in calculating capital charges for operational risk. The FME finds that extensive research needs to be undertaken before calibration of these factors will be decided upon.

The FME strongly supports the ideas set forth in the supervisory review and market discipline pillars. According to present Icelandic legislation, the FME does not have the authority to require banks to hold capital in excess of the minimum level and sees the proposals in the supervisory review pillar as a way to strengthen the overall soundness of the financial system. The FME believes that financial institutions should be required to publish all necessary information to increase the effectiveness of the market discipline.

2.0 A New Capital Adequacy Framework

The FME welcomes the Committee's review of the 1988 Capital Accord. The FME notes that the methods used to determine the capital charges for credit risk in the 1988 Capital Accord are not overly sophisticated. Rapid financial innovation and the growing complexity of financial transactions have reduced their relevance. Although the 1988 Capital Accord has been useful to maintain a minimum level of capital, the FME acknowledges the need for the Accord to evolve along with changes in the financial market.

The FME wants to emphasize the importance that the new framework should suit small financial institutions as well as larger ones. The FME also emphasizes the importance that the new framework at least maintains the overall level of capital currently in the banking system.

Regarding the scope of application, the FME welcomes the proposals to extend the revised Accord to include on a fully consolidated basis holding companies that are parents of banking groups. The FME does agree with the Committee that the combination of a fully consolidated approach at the top level within banking groups and at lower levels on a sub-consolidated and/or stand-alone basis is the best way to preserve the integrity of capital and to eliminate double gearing.

3.0 Minimum Capital Requirements

In the new capital adequacy framework, changes are proposed in the assessment of regulatory capital requirements based on credit risk and plans made to set regulatory capital requirements based on other risks.

3.1 Credit Risk

The FME welcomes the approaches for making the New Accord more sensitive to credit risk. The Committee is proposing a range of options for addressing credit risk. The range of options begins with the standardised approach and extends to include a foundation IRB approach and an advanced IRB approach. Following is a discussion of issues, which the FME finds most important.

3.1.1 Standardised approach

The Committee proposes to permit the use of external credit assessments assigned by rating agencies in determining the risk-weighting category for various banking book assets.

External rating agencies

The FME is concerned that because of the very limited application of external ratings in Iceland, the method of external rating could negatively affect the competitive position of domestic firms vs. foreign firms. Consequently, the FME has strong reservations about relying on external credit rating agencies and their ratings in assessing regulatory capital requirements. Also, rating agencies may not have access to all relevant information and their ratings have proved to be erratic at times, e.g. in the recent crisis in East Asia. The FME is concerned that in times of economic and/or financial difficulties and consequent rating downgrades, the use of external ratings for regulatory capital requirement purposes might deepen the business cycle, as the downgrade might simultaneously create a need to increase capital.

If the method of external rating is to be used in the capital framework to determine the risk-weighting categories, the FME emphasizes the need to create conditions for domestic credit rating firms to assign the ratings.

Sovereigns

The Committee proposed that the zero-weighted category should be limited to sovereigns with the highest credit quality. Under the Standard & Poor's methodology, to take an example, this means that sovereigns that have a rating of AA- and above would be in the zero-weighted category. Claims on countries rated A+ to A- would receive a 20% risk weight. A modified treatment would be available for banks' exposures to their own sovereign (or central bank) denominated in domestic currency and funded in that currency. The FME is of the view that there is little justification for drawing the line between the AA category and the single A cateory, as the Committee does. Analyses have shown that the default probabilities are only insignificantly greater in the A category than in the AA category. There would appear to be a good case for drawing the line at the bottom of the A category which would also be closer to the level where financial institutions commonly separate investment grade claims from others.

Banks

For claims on banks, two options are under consideration, one based on the assessment of the sovereign of the bank's country of incorporation and one based on the rating of the bank itself. The FME favours option one, i.e. basing the credit risk weighting on the risk weighting of the sovereign of incorporation, but in one category less favourable. The Bankers´ and Securities Dealers´ Association of Iceland and the European Banking Federation (EBF) also share this stance. Icelandic banks are small in comparison to other banks and their operation is mainly domestic. The FME fears that financially sound Icelandic banks will never get a risk weighting of AAA to AA- and therefore be excluded from the 20% risk category. The FME is against the Basel proposition that each

jurisdiction will have the discretion to choose which of the two options it will apply and recommends that uniform approach will be used.

Risk differentiation

The standard weighting of claims on corporates remains at 100% but a weight of 20% can be assigned to claims on corporates of a very high quality and a weight of 150% can be assigned to claims on corporates that are of very poor quality and to unsecured portions of assets that are past due for more than 90 days, net of specific provisions. The FME supports the application of a risk weighting of 150% to this type of assets and the 90 days rule.

Credit risk mitigation

The 1988 Capital Accord may, in some instances, have been unfavorable to the development of specific forms of credit risk mitigation by placing restrictions on both the type of hedges acceptable for achieving capital reduction and the amount of capital relief. It has also left open the treatment of imperfect credit risk protection (maturity mismatches, asset mismatches, potential future exposure on hedges), resulting in the development of different national policies. The FME strongly supports the Committee's proposal of a more consistent and economic approach to credit risk mitigation techniques, covering credit derivatives, collateral, guarantees, and on-balance-sheet netting. The FME believes that these new proposals will stimulate the use of credit risk mitigation techniques and enable banks to substantially improve their risk management. The increase in the range of collateral instruments eligible for credit risk mitigation is welcomed but the FME thinks that other physical assets than real estates, in particular ships and aircrafts, should be added to the list of eligible collateral.

Claims secured on commercial real estate

Because of experience in numerous countries that commercial property lending has been a recurring cause of troubled assets in the banking industry over the past few decades, the Committee holds to the view that mortgages on commercial real estate do not, in principle, justify other than a 100% weighting of the loans secured. The FME experience is that credit losses of claims secured by mortgage on commercial real estates are somewhat smaller than to claims in more specialised real estates or to claims not secured at all. Because of that, the FME finds that the treatment of claims secured by mortgage on commercial real estates should be risk weighted at 50%.

3.1.2 Internal ratings

The FME has always stressed that the Internal Rating Based Approach could not only be used by the so-called "sophisticated" internationally active banks but also by wider range of banks. Thus, the FME welcomes the Basel's view that, although the new framework's focus is primarily on internationally active banks, its underlying principles are intended to be suitable for application to banks of varying levels of complexity and sophistication.

The Committee has put forward the idea of an evolutionary IRB approach, i.e. a foundation IRB approach and an advanced IRB approach. In the foundation IRB approach banks meeting robust supervisory standards will input their own assessment of the probability of default associated with the obligor. Estimates of additional risk factors,

such as loss incurred by the bank given a default and the expected exposure at default, will be derived through the application of standardised supervisory estimates. The advanced IRB approach will be available for banks that meet more rigorous supervisory standards. Under this approach, more of the risk components will be estimated internally by a bank. The FME welcomes the idea of an evolutionary IRB approach because it will require banks to develop and enhance their existing risk management systems. The FME wants to emphasise the important role of supervisory authorities in approving internal rating systems of financial institutions and how important it is to ensure comparability of supervisory methods between banks and countries.

In respect of the adoption of the IRB approach across exposure types and business units the Committee states that a banking group that has met the requisite minimum requirements and is using the IRB approach for some of its exposures must adopt the IRB approach across all exposure classes and across all significant business units within a reasonably short period of time. This is done to minimise the so-called cherry-picking. Exceptions from this rule are accepted for exposures in non-significant business units, subject to national discretion. The FME has some concerns that smaller banks might have problems in fulfilling these stringent rules. Smaller banks might have one or more exposure classes for which they have developed sophisticated rating methodologies and processes. As for the remainder they might use significantly less sophisticated methods and processes, e.g. base the risk assessment on the opinion of their credit experts rather than on statistically estimated risk factors. For these exposures, the cost of developing an IRB approach might be very high in relative terms, without any important benefits for the overall risk analysis. Because of this, the FME would support exemption for some types of exposures if they were not material in terms of size and perceived risk profile.

The IRB approach provides a similar treatment for corporate, bank and sovereign exposures and a separate framework for retail exposures. Because of the different treatment of corporate exposures and retail exposures the FME has some concerns of the flexibility in how small business lending is classified. Some lending to small and medium size business has greater risks than other retail portfolios and, to the extent that there are capital differences between retail and corporate portfolios it would be undesirable for all such lending to be classified as retail regardless of risk. The FME believes that further criteria are appropriate to distinguish between corporate exposures and retail exposures.

3.2 Operational risk

The Committee offers three approaches to minimum capital requirements for operational risk. These approaches are a basic indicator approach, a standardised approach and an internal measurement approach.

Because of the limited availability of figures for operational losses in Iceland, the FME believes that Icelandic financial firms will initially use the basic indicator approach for calculating the charge for operational risk. The FME finds that further researches need to be undertaken before the fixed percent, alpha, is decided upon.

The FME is aware of the difficulties to determine the beta factor for each business line in the standardised approach, especially is it difficult to estimate operational losses that the

calculations of relative weightings of the business lines are built upon. Because of this, the FME believes that further researches are needed before the calibration of the standardised approach will be decided upon.

The FME supports the intention of developing internal-based methodologies for operational risk, so called internal measurement approach, mainly because it will give banks incentives to collect internal loss data.

4.0 Supervisory Review

With regard to the supervisory review pillar, the Committee notes that supervisors should focus the attention of bank managements on developing an internal capital assessment process and on setting targets for capital that are commensurate with a bank's particular risk profile and control environment. This internal process would then be subject to supervisory review and intervention where appropriate. Supervisors should also have the ability to require banks to hold capital in excess of the minimum. The FME welcomes these proposals. The FME believes that large and well managed financial institutions in Iceland should have regulatory capital above 10% and the smaller ones even higher. According to present Icelandic legislation, the FME does not have the authority to require financial institutions to hold capital in excess of the legally stipulated minimum of 8%.

The Committee recognizes that a bank's decisions on the actual level and structure of capital will largely be based on qualitative factors. Regardless of the methodology, banks must be able to demonstrate that the chosen internal capital targets are well founded and should have a robust stress-testing process in place to support their assumptions. The FME very much welcomes these ideas. Financial institutions in Iceland have mainly focused on the regulatory minimum capital ratio and not on internal capital targets. These proposals could change that and result in a more internally focused way of choosing an "appropriate" capital level. The idea of having a stress-testing process in place to support the internal capital targets would undoubtedly lead to more conservative capital targets.

Because of considerable heterogeneity among banks in terms of the nature of the interest rate risk in the banking book and the process for monitoring and managing it, the Committee has concluded that it is most appropriate to treat interest rate risk in the banking book under the supervisory review pillar. The FME believes that all interest rate sensitive items not already included in the trading book should be covered by the new framework. According to the proposals, no specific methodology to handle interest rate risk in the banking book is prescribed. Supervisory authorities should be satisfied that the methodologies developed by regulated institutions are consistent with the risk profile and with the sophistication of activities and risk management systems. The FME finds it important that behavioral assumptions, e.g. the treatment of deposits for which actual behaviour differs from contractual terms should be consistent between countries because they have a crucial influence on the assessment of exposure to interest rate risk. According to the proposals, supervisory authorities will determine the need for a specific amount of capital (corrective action) on the basis of their assessment of risk management systems and of the reported exposure to interest rate risk. The FME would find it helpful

if some form of guidelines would be made to avoid discrimination in implementing corrective actions.

5.0 Market Discipline

The FME regards market discipline as a very important factor in surveillance. The New Accord anticipates that banks will be permitted to use internal methodologies to calculate capital requirements for credit risk and operational risk. Given the influence of internal methodologies on the capital requirements established, the FME believes that comprehensive disclosure is important for market participants to understand the relationship between the risk profile and capital of an institution.

The FME agrees with the Committee when it states that supervisors have a strong interest in facilitating effective market discipline as a lever to strengthen the safety and soundness of the banking system. Market discipline also imposes incentives to conduct business in a safe, sound and efficient manner. The increased reliance on financial markets means increased market surveillance, which should lead to increased safety and soundness in banks and financial systems.

The New Accord distinguishes between core and supplementary disclosures. Core disclosures are those that convey vital information for all institutions and are important to the basic operation of market discipline. Supplementary disclosures are important for some, but not all, institutions and depend on the nature of the institution’s risk exposure, capital adequacy and methods of calculating capital requirements. The Committee expects all institutions to disclose the basic information but recommends that sophisticated internationally active banks also disclose supplementary information. The concept of materiality will guide the necessity for supplementary disclosures to be made.
The FME thinks that the disclosed information should be provided in semi-annual financial reports and should include quantitative and qualitative details on the respective bank's financial condition and performance, business activities, risk profile and risk management activities. In Iceland, financial statements disclosures contain much of this information. The FME believes that financial institutions should be required to publish all necessary information to increase the effectiveness of the market discipline, i.e. enabling counter parties to make well-founded risk assessments.

The FME finds that the effect of disclosure of capital requirements imposed by supervisors must be considered carefully. Disclosure of capital requirements imposed by supervisors could impact significantly on the market. The FME believes that the arguments against the publication of capital ratios imposed by the supervisor outweigh the arguments in favour. FME supports the proposition to prohibit publication of the capital ratios required by supervisors by individual institutions if that is workable because institutions registered on a stock exchange have to provide the market with all sorts of information. The FME fears that because of the potential risk that institutions with a supervisory capital requirement at or very near to the minimum requirement will use the publication of that figure to competitive advantage.