FINANCE & TECHNOLOGY MANAGEMENT

COMMENTS ON THE CONSULTATIVE DOCUMENT : THE NEW BASEL CAPITAL ACCORD

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PRELIMINARY

Finance & Technology Management SA is a specialist consultancy in risk management advice to the financial services sector. We welcome the consultative document issued by the Basel Committee on Banking Supervision. We set out below our comments on the principal areas of the document which we believe merit further reflection. Our comments take into account over ten years of advice to a wide range of banking groups essentially in France and Belgium.

CREDIT RISK – THE INTERNAL RATINGS BASED APPROACH – RULES FOR CORPORATE AND RETAIL EXPOSURES

Treatment of exposures to small and medium-sized proprietor-run corporates

We endorse the committee's comments regarding the definition of lending to small businesses(Overview paras 115-116).We should like to see greater clarity in the definition of how these exposures should be treated, to avoid the risk that exposure to economically related parties might be split between retail and corporate exposure, with consequent effects on, for example, the granularity calculation.

One solution would be that all exposures to related parties must be aggregated for the granularity calculation, regardless of whether they are classified as retail or corporate. An aggregate quantum limit could also be set within the definition of retail, such that aggregate exposures over a certain limit must be treated as corporate unless it can be demonstrated that the individual exposures have the character of retail loans. And a disclosure requirement for such exposures could be made, to permit the supervisor to assess whether the treatment rests within the spirit of the Accord.

More broadly, it may be helpful to indicate more precisely what types of relationship between borrowers should cause them to be treated as single-borrower risk concentrations.

RULES FOR RETAIL EXPOSURES

Expected Loss (EL)

We believe that this term is used in the consultative document to mean different things. On the one hand the document specifies that EL is calculated on the basis of an average. On the other hand, the document also states that PD (EL = PD * LGD) is estimated on the basis of annual volatility. In this latter case, we suggest that Unexpected Loss (UL),

calculated on the basis of default volatility, would be more appropriate. Furthermore, we wonder if the same term is used with different meanings in different parts of the document (cf para 185 in the IRB Approach supporting document). A clear distinction between EL ("average" risk) and UL ("volatility risk") would be helpful. As a consequence, the issue of maintaining capital requirement for EL, or not, could be more easily solved.

Formula for derivation of risk weights

The consultative document proposes that the risk weight formula for retail exposures take no account of the maturity of the exposure. In our experience, maturity is a material factor in the determination of risk for different loans of otherwise the same nature. To include this risk factor, there might be a further segmentation by maturity. Maturity scale should take amortization profile into account, or a duration equivalent. However, to be adequately exploited, this would require a set of ratings and PD for each time-horizon, which might prove difficult to obtain for the majority of banks. Therefore, we propose that maturity be incorporated as a factor in the risk weight formula, applying the same logic as for the inclusion of maturity, in certain circumstances, in the risk weight formula for corporate exposures in the IRB approach.

The committee poses the question as to whether different risk weights are warranted for different product types. We note the portfolio segmentation required, together with the option left open for banks to apply such additional segmentation techniques as they feel appropriate to the structure of their business. We consider that this segmentation permits sufficient differentiation of risks (and thus sufficient differentiation in the measurement of the risks) without the necessity of defining a separate set of risk weights per product type.

Collateral, on-balance sheet netting and guarantees

Although these subjects are covered in the standard approach and both the IRB approaches, we have found no mention thereof in the rules for retail exposures.

Minimum Requirements

We feel that the list of minimum requirements which banks must meet in order to be eligible for the IRB approach is well thought-out and comprehensive. Our only reservation would be on leasing weightings, which might prove somewhat excessive.

Granularity adjustment to capital

The consultative document proposes to exclude all retail exposure from the granularity adjustment. We consider that granularity has a particular relevance to retail exposures to SME’s and their proprietors. Therefore, we propose that this be recognised in the granularity calculation. A definition of related borrowers would be helpful, bearing in

mind the importance to the definition of the proprietor as an individual, not merely corporate relationships.

RULES FOR CORPORATE EXPOSURES

Techniques for the management of the structure of credit portfolios

We wonder if specific mention should be made of the treatment to be applied to credit risk mitigation techniques such as silent participations in loans, whether financed or not, asset swaps, and the different types of synthetic products which transfer credit risk from one party to another, such as asset swaps and options on spreads.

COMMENTS ON THE FORM OF THE DOCUMENT

(references are to paragraphs in the main consultative document)

We appreciate that the consultative document was produced in the shortest time possible in order to give more time for the consultation period. It is evident that the document will be subject to further redrafting before the definitive New Basel Capital Accord is published.

Certain issues are addressed a number of times in different places: for example, the use of statistical models in the credit rating system, paragraphs 251, 266-7, 281. The document would be clearer if the repetitive elements were eliminated.

Some terms appear to be used with slightly different meanings in different parts of the document: for example, 'rating system' in paragraphs 237 and 302.

The basis for some elements of systems or formulae is not always explained: for example, in the formula for derivation of risk weights for corporate exposures, the multiplier of 976,5 , paragraph 174. On the other hand, there are some definitions given without the defined terms being used subsequently : for example, the definition of subordination in the foundation IRB approach, paragraph 311 .

CONCLUSION

We recognise the quantity and quality of research, enquiry and reflection which have gone into the preparation of the consultative document, and we appreciate the opportunity to make comments. We look forward to the publication of the definitive version of the new accord.