PHILIP J. MARR
Director of Banking

Our Ref: CLM/BAP

Basel Committee on Banking Supervision
C/o Bank for International Settlements
CH-4002
Basel
Switzerland

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By E-Mail – BCBS.Capital@bis.org

Dear Sirs

THE NEW BASEL CAPITAL ACCORD – SECOND CONSULTATIVE PACKAGE

The Commission's Banking Division has considered the Basel Committee on Banking Supervision's proposals, as laid out in the Consultation Documents issued as part of the second consultative package, and would like to make the following comments. The Committee may wish to note that members of the Division attended the inaugural seminar in 1999 and the April 2001 Focused Workshop of the Financial Stability Institute and workshops presented by the Financial Services Authority in the UK.

(i) After much contemplation of the Internal Ratings Based approach to capital requirements for credit risk ("IRB") we feel more consideration needs to be given to how it would be applied in small jurisdictions and, indeed, developing countries.

One particular issue is how it would be applied to subsidiary banks in small jurisdictions etc. It is not unreasonable to suggest that there will be a limited supply of expertise available to the supervisory community worldwide to devote to the design and setting up of models and to their implementation. There is also a limited supply of expertise available to the banking community itself and it remains to be seen how easily credit assessment systems can be adapted to enable them to be implemented by the lending bankers in the credit granting units of the banks. Once the basic model is approved credit assessment systems will clearly have to be refined and simplified if they are to be rolled out effectively in a large international banking group.

In order to make best use of the limited expert resources in the field we would see the need to adopt a home/host supervisory approach to embrace subsidiaries of large international banks operating in smaller/developing jurisdictions. One way forward would be along the following lines:

(a) Employ a **significance test** for applying the IRB approach to subsidiaries: an initial suggestion would be a significance threshold at 5 per cent of Group credit facilities/or risk weighted assets.

(b) Ownership of the approval process would clearly rest with the home supervisor but supervisors from jurisdictions with 'significant' credit risk generating units could be invited to join a **college of regulators** to provide input in the approval process and ensure there is full understanding of the approved methodology before it is rolled out to the significant units of the banking group.

(c) Jurisdictions with non significant credit units would not need to be involved in the IRB process.

(ii) The revised Accord is to apply to holding companies that are parents of groups that are predominantly banking groups. The definition of such "predominantly banking groups" remains imprecise and is open to misinterpretation. Furthermore several of such holding companies may be established in jurisdictions where they are not banks and may be unregulated.

Similarly the definition of "financial subsidiary" needs to be more precise. Does it include company administration, trust administrators and bureaux de change? Further clarification would be appreciated here.

(iii) Having identified the benefits of recognising rating agencies ("external rating assessment institutions") it would be a pity if the benefits could not be dissipated worldwide at an early stage rather than waiting for individual supervisors to approve all the ERAIs present in their jurisdiction. We have a strong preference for some central registration of rating agencies through the BIS or other international body. Failing that, we would adopt a home/host supervisor approach for subsidiaries – smaller jurisdictions etc could allow rated assets if the home supervisor of the parent bank had already approved the ERAI.

(iv) With reference to Pillar II it is noted that management of bank **subsidiaries** are expected to have assessed their own capital requirements, even if that is drawn from group policy. It is not clear what benefit this exercise would achieve where subsidiaries (such as those operating in this jurisdiction) have

obviously excess capital, with many typically above 20 per cent. Clearly this is an important exercise at the consolidated level. Could there not be a dispensation for banks with risk asset ratios in excess of a certain level or for subsidiaries?

(v) At the technical level on operational risk, in the Basic Indicator Approach, the indicator is proposed to be gross income. For banking subsidiaries this figure could be rather easily manipulated. This means that the indicator only has relevance on a consolidated basis. It is therefore suggested that this indicator might be inappropriate for banks which are wholly owned subsidiaries of other banks.

(vi) It is noted that in the Comprehensive Approach to Credit Risk Mitigation (CRM) techniques a w factor of 0.15 is added to address risks not explicitly covered by the rest of the formula. This 'w factor' appears to be double counting as it is additional to capital charges separately proposed which would address the operational risks in credit risk mitigation.

(vii) On operational risk at the more contemplative level we have struggled to be convinced that we have got the balance right. We fully endorse the Committee's comment in the Operational Risk Consultative Document that "a rigorous control environment is essential to prudent management of, and limiting of exposure to, operational risk." An approach which implies throwing more capital at a problem without attacking the root causes of the problem (ie an insufficiently rigorous control environment) seems to us intuitively misplaced. Attempting to devise an armoury of proxy indicators may not move us very far forward. If the root problem does not respond to incremental capital we should perhaps be refining our supervisory approach to improving controls. That said, in our experience recently, we have been surprised that risk mitigants for operational risk, in the form of standard bankers' blanket bond and professional indemnity insurance policies, have effectively compensated for the financial losses in two cases of serious operational risk. They do not, of course, compensate for the management time expended in sorting out the original errors and negligence which is why we feel supervisory efforts need to be focussed on the control environment.

(viii) Pillar III requires all banks to fully disclose core and supplementary information semi-annually. This information is said to be vital for all institutions and is important to the basic operation of market discipline. However where banks (such as the 50 subsidiaries in our jurisdiction) are wholly owned by other banks it is difficult to see the merit in requiring full and semi-annual disclosure as proposed.

Finally, we look forward to the assimilation of on-going work on operational risks and other risks and the surveying of new initiatives undertaken by the leading banks in the field.

Yours faithfully

Philip J Marr	Christopher M Le Marchant
Director of Banking	Deputy Director of Banking