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

Dear Danièle,

Comments on the Second Consultative Package of the New Basel Capital Accord

Further to my letter of 28 May wearing my "EMEAP" hat, I am now writing to provide you with the views and comments of the HKMA and of the Hong Kong banking industry (inevitably there is some repetition of points from the previous letter). Copies of the detailed comments put forward by the two banking industry associations[1] are attached as annexes.

In general, we are supportive of the new capital framework's aims of aligning regulatory capital requirements more closely with the key elements of banking risks and providing incentives for banks to enhance their risk measurement and management capabilities. The current proposals will however raise significant issues for banks in Hong Kong in terms of capital requirements and resources. They have noted that there will be significant additional costs, and it is not clear that these will be

[1] The Hong Kong Association of Banks and the Hong Kong Association of Restricted Licence Banks and Deposit-taking Companies.

outweighed by the benefits in terms of improved credit risk management practices. There are particular concerns relating to several specific aspects of the New Accord, such as the calibration of the various approaches (notably the Foundation IRB) and the recognition of collateral for credit risk mitigation. Some potential problems that may be encountered by national supervisors and banks when implementing the proposals will also need to be resolved.

The major issues and comments are summarised in the following paragraphs. We would be grateful if the Basel Committee could take account of these issues and concerns in finalising the New Accord.

KEY ISSUES AND CONCERNS

Impact on capital requirements

1. While the Basel Committee's intention is stated as being to maintain the overall level of capital in the banking system, the proposals seem certain to result in higher capital requirements for banks in Hong Kong. It is expected that the new capital charge for operational risk will more than offset by a significant amount any reduction in capital requirements under the standardised approach.

2. Based on the preliminary results of a quantitative impact study[2] that we have undertook in respect of the standardised approach, the capital adequacy ratio (CAR) of a representative sample of banks in Hong Kong would be reduced by an average of 258 basis points. This reduction is mainly attributable to the capital charge for operational risk (using the basic indicator approach) (see point 4 below). Applying the standardised approach for credit risk would produce a reduction in CAR of an average of 13 basis points. This illustrates the point that the current proposals will not produce any savings in capital charge for credit risk to offset the effect of the capital charge for operational risk. This can be explained by the fact that not many of the banks' corporate borrowers are externally rated, while the recognition of collateral is too limited to have much impact in terms of risk mitigation (see points 16 to 19 below). It is worth noting that the major increase in risk weighted exposures derives from claims on banks (see attached annex).

3. Any resultant increase in capital requirements could potentially disadvantage banks in Hong Kong vis-à-vis other foreign banking

[2] Note this was a separate exercise from the Basel Committee's own QIS, using a survey format designed by the HKMA.

institutions that can benefit more from the proposed capital changes. I imagine that the same would apply to other banks in the Asian Region and those in emerging markets elsewhere. The Basel Committee is therefore requested to review the appropriateness of the current calibration of the New Accord in the light of these results.

Capital charge for operational risk

4. We support the explicit recognition of operational risk for capital purposes, though this is conditional on satisfactory resolution of the difficult measurement issues. However, the allocation of a 20% capital charge for operational risk is believed to be too high for banks in Hong Kong, thus leading to an overall increase in their capital requirements (see above). As the business activities conducted by most banks in Hong Kong are largely conventional in nature, such as retail banking and commercial lending, their operations are generally less complex than those engaged in by large international banks. The basic indicator approach (which is the only one where a capital factor is presently provided) would reduce the CAR of the surveyed banks by an average of 250 basis points[3]. This seems excessive and not in line with the actual operational losses experienced by banks.

5. As pointed out by some banks, there are problems with the methodologies used for capital measurement under operational risk. It appears that the internal measurement approach will be too complicated for adoption by most of the banks in Hong Kong (at least initially). The other two approaches, namely the basic indicator approach and the standardised approach, are however based mainly on business volume (e.g. gross income or annual average assets) and hence not risk-driven. This would not therefore provide incentives for banks to improve their operational risk management.

6. Moreover, the risk measurements for the two approaches could result in double counting in terms of credit risk captured under Pillar 1. For example, documentation risks are covered by the *w* factor in credit risk mitigation, and fraud risks are recognised through credit losses such as credit card charge-offs. The boundary between an operational loss and a credit loss is not entirely clear in such cases. In particular, our banks consider that the minimum *w* factor of 0.15 for cash secured transactions duplicates the operational risk change for documentation/enforcement risk.

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[3] The 300 basis points impact maintained in my letter of 28 May applied to a wider range of banks.

7. In light of the above, it is considered necessary for the Basel Committee to review whether the methodologies and benchmarks proposed for operational risk and credit risk mitigation should be revised.

<u>Status of the standardised approach</u>

8. It is likely that many, if not most, banks in the region will adopt the standardised approach, at least initially. 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.

<u>Cross-border implementation of the New Accord</u>

9. 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 adopt different approaches for the calculation of capital charge or 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, as far as possible, their approaches to the New Accord. The Basel Committee may also wish to encourage supervisors to disclose how they will exercise national discretion under the Accord.

Implementation process

10. Given the complexity of the New Accord, implementing the proposals will entail significant resources and require extensive work by both national supervisors and banks. There will be a need for more guidance and assistance from the Basel Committee, and possibly the Financial Stability Institute, to help smooth the implementation process in the period leading up to 2004.

11. On the part of banking supervisors, for example, there will be a considerable amount 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.

12. The implementation schedule is extremely tight for banks which have complex global operations and are seeking to adopt the IRB approach in 2004. In particular, the requirement to adopt IRB across all exposure classes and across all business units "within a reasonably short period of time" seems too onerous. Further clarification is required of what an acceptable period of time would be. As discussed at the recent CPLG meeting in Prague, it may be reasonable to allow an extended implementation period (i.e. a number of years) provided that there is a clear intention and plan to proceed towards full adoption.

Risk weights for retail portfolios

13. We understand that the Basel Committee will review the need to adjust the risk weights for retail portfolios in the standardised approach depending on the outcome of the work currently being undertaken in respect of the IRB approach. The following figures for Hong Kong may provide some assistance to the Committee.

14. According to figures reported by a sample of local banks that have a significant share of the residential mortgage business in Hong Kong, the annual write-off ratio[4] in respect of their residential mortgage loans was 0.02% in 1999 and 0.29% in 2000[5] on average. For the years of 1997 and 1998, the ratio was almost zero. We believe, on the basis of other available information, that this would also hold good for earlier years. The write-off ratio in 2000 therefore seems to be unusually high, reflecting the impact of the Asian crisis on the property market. However, if we take this figure (i.e. 0.29%) as a conservative indicator of average expected loss in the residential mortgage portfolio and furthermore assume a loss given default (LGD) of 20%[6], this would imply a probability of default (PD) of 1.45%. The corresponding risk weight for such a PD under the IRB approach for retail exposures would be 33%[7]. This suggests that the risk weight of 50% for residential mortgages under the standardised approach is conservative and may even be on the high side.

15. This reinforces our view that it would be overkill to increase the risk weight of residential mortgage loans from 50% to 150% once they are past due for more than 90 days. It seems 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 mortgage loans 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 mortgage loans.

<u>Limited recognition of collateral</u>

16. It is not proposed in the New Accord that real estate collateral, which is a common form of collateral for banks in Hong Kong, should be recognised for the purpose of credit risk mitigation under the standardised approach. While such collateral is certainly subject to fluctuations in market value and is usually less liquid than financial collateral, it is an important means of mitigating losses on defaulted

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[4] The annual write-off ratio is the value of residential mortgage loans written off in a year as a percentage of the average outstanding amount of total residential mortgage loans during that year.

[5] The higher ratio in 2000 reflected the increase in write-offs due to the sale of repossessed properties whose value dropped substantially since the peak in 1997 (up to around 50%).

[6] Banks in Hong Kong are already subject to a guideline that stipulates that the loan-to-value ratio of residential mortgage loans cannot exceed 70% at the time of origination. The assumption of a 20% LGD for such loans implies an additional 20% loss on top of the 30% cushion.

[7] Risk weight = LGD/50 x BRW, where BRW (benchmark risk weight) is 83% for the corresponding PD of 1.45%.

loans and it is therefore more appropriate to deal with these issues through applying appropriate haircuts than by disregarding the value of the collateral entirely.

17. In the case of Hong Kong, where the legal, judicial and valuation systems are well established, the average holding period for banks to liquidate their foreclosed properties in the market is about six months. The annualised price volatility of residential properties and commercial properties based on the data for the past 10 years[8] was 14.2% and 17.7% respectively. Based on the estimated price volatility, a 6-month holding period and a 99% confidence interval, the appropriate haircut would be 23.4% for residential properties and 29.1% for commercial properties.

18. Given the above analysis, we consider that, where objective standards regarding enforceability and valuation can be satisfied, real estate should be accepted as collateral subject to appropriate haircuts. The value of real estate collateral should similarly be recognised for the calculation of past due assets under the standardised approach. Alternatively, there should be discretion for supervisors to accept such collateral based on the circumstances of their own jurisdictions.

19. Broader recognition of collateral (including other forms of physical collateral) would in general help to mitigate the impact of the likely net increase in capital requirements due to operational risk. Eligible physical collateral could be subject to appropriate, jurisdiction specific, objective standards regarding legal enforceability and supervisory established *w* factors and haircuts to adjust for the risks of documentation, valuation and liquidity.

Calibration issues relating to the IRB approach

20. Some banks have expressed doubts as to whether there are sufficient incentives in the present calibration of the New Accord to justify adoption of the IRB approach. Based on their preliminary estimates, the benchmark risk weights under the IRB approach for higher risk assets, such as exposures to small and medium enterprises, are much higher than those under the standardised approach. The concern is that this will create a disincentive for banks to migrate to the IRB approach and may indeed give banks applying the standardised approach a competitive advantage.

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[8] The data have been extracted from the time series of the price indices by property type reported in "Hong Kong Property Review" issued by the Rating and Valuation Department of the Hong Kong SAR Government.

21. 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 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.

22. 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).

23. 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.

Pro-cyclicality

24. At the macro-economic and industry levels the New Accord may not cause a "pro-cyclicality" effect as banks will generally be expected to manage capital on a forward looking basis with adequate cushion to absorb down-side risks. However, our banks have expressed concern that there may be a pronounced effect on individual industries and individual borrowers which experience a deterioration in their risk profile as all banks seek to reduce their exposure simultaneously. Such herd behaviour could result in over reaction by the market and exacerbate the underlying problem.

Market interpretation

25. 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 IRB approach, the CAR 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.

OTHER COMMENTS

Pillar 1

26. There is a general perception that even the standardised approach for credit risk may be too complicated and costly for some smaller banks. We welcome the initiative to develop a simplified version of the standardized approach for such banks (although this should not preclude local supervisors from exploring other options).

27. The Basel 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. We consider that it would be reasonable to apply the treatment to domestic currency obligations of non-sovereign entities including corporates.

28. There are views from the banking industry that the 20% conversion factor for undrawn commitments with an original maturity of up to one year should only apply where there is a specific contractual commitment, not where cancellation of the commitment is subject only to general common law concepts of reasonable notice (e.g. credit card limits or commercial and personal lines of credit for which no commitment fee is paid). A clearer definition of the "commitments" to which this capital charge applies is therefore required.

29. Our banks consider that the granularity adjustment in the IRB approach is an unnecessary and costly complication which could be dealt with as an issue under Pillar 2.

Pillar 2

30. We support the supervisory review process, which is generally consistent with the approach adopted in Hong Kong. Care will however need to be taken that the principle of management accountability is maintained and that supervisors do not attempt to “second-guess” decisions which are properly left to directors and management. Further guidance on this may be required from the Basel Committee.

31. We agree that banking book interest rate risk should be outside the scope of Pillar 1. The definition of “outlier banks” for interest rate risk in the banking book looks reasonable. As for the standardised interest rate shock, the definition for G-10 countries, i.e. parallel rate

shock of 200 basis points upward or downward, is simple and easy for banks to monitor, but the definition for non G-10 countries (which will apply to Hong Kong) is complicated and creates uncertainty for banks to monitor. It is suggested that the definition for G-10 countries be used with an added margin to the quantum of interest rate shock in recognition of higher volatility in the interest rates of non G-10 countries.

Pillar 3

32. Our banks are generally supportive of the new Pillar 3 requirements. But there are concerns that the proposed level of detail is excessive and that a more appropriate balance needs to be struck between the benefits of greater transparency and the costs of producing the information. This view applies particularly in relation to the disclosure standards for IRB which, it is suggested, will tend to confuse market participants with information that is voluminous, complex and difficult to interpret. There is also concern that some of the information is of a proprietary nature.

33. We believe that these concerns are also shared by banks in other jurisdictions. It is suggested, therefore, that the current disclosure proposals should be reviewed to ensure that they are relevant and do not impose an excessive reporting burden.

I hope the above comments will be useful for the Basel Committee to shape the final proposals. Please let me know if any clarification is required.

Yours sincerely,

D T R Carse
Deputy Chief Executive

Encl.

Analysis of Impact of the New Accord on
A Representative Sample of Banks in Hong Kong

Impact Due To	Net Change in Total Risk Weighted Exposures (%)	Net Change in CAR (%)
Operational Risk	+22.57	-2.50
Credit Risk	+0.96	-0.13
• *Claims on Central Government and Central Banks*	*-2.05*	
• *Claims on Multilateral Development Banks*	*-0.66*	
• *Claims on Corporates and Private Individuals, and Residential Mortgages*	*-2.02*	
• *Claims on Public Sector Entities*	*+1.16*	
• *Claims on Banks*	*+3.23*	
• *Assets Past Due for 3 Months or More*	*+1.00*	
• *Commitments of Less Than 1 year*	*+0.30*	
Total	+23.53	-2.58