INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

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May 22, 2001

Mr. William J. McDonough
Chairman, Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland

Dear Mr. McDonough:

In response to your letter of January 12, 2001, I take pleasure in attaching comments on the proposed new Basel Capital Accord. These comments, prepared by an interdepartmental working group, represent the views of Fund management and staff. Please note that a draft of these comments has been shared with the Executive Directors of the Fund at an informal seminar. My staff will be pleased to discuss these comments further, as needed.

We have been impressed by the very substantial efforts by the Basel Committee to engage all interested parties in the consultative process and to actively elicit comments on the proposals. We also appreciate the time you and your colleagues took to present the proposals to the Executive Directors, managements, and staffs, of the IMF and World Bank in the seminar last March. We trust that these outreach efforts will contribute to the widest possible acceptance of this ambitious new Accord.

We look forward to continued close cooperation with you and your secretariat with regard to the proposals and the implementation of the new Accord. We welcome public disclosure of the different comments on the various proposals, including our own, on the website of the Basel Committee.

Yours sincerely,

H. Köhler

Attachment

INTERNATIONAL MONETARY FUND

IMF Staff Comments on the January 2001 Proposals of the Basel Committee on Banking Supervision for a New Capital Adequacy Framework for Banks

Prepared by an Interdepartmental Working Group

May 9, 2001

EXECUTIVE SUMMARY

Fund staff supports the objectives of the new proposals. In particular, staff commends the Basel Committee on Banking Supervision (BCBS) for proposing a more comprehensive risk-based approach placing more responsibility on banks; greater emphasis on the supervisory process and relying more on market discipline, in part by increasing disclosure requirements. Nonetheless, a number of issues remain to be resolved before the new framework can be effectively implemented and the challenge is to create an incentive framework that will ensure universal adoption of the intent of the proposals. In this context, the Basel Committee's extensive outreach in the consultation process is to be commended, but work to resolve some key issues of substance would be also welcomed. Notably

- In view of the significance of the Accord as a new global standard, the need for a common regulatory framework and a level playing field, the new Accord should apply to all banks in all countries. This may require a simplified version of the standardized approach, although staff recognizes the difficulties in balancing simplicity and closer alignment between risk and capital requirements;

- More disclosure will be required of rating agency and export credit agency rating methodologies, because countries will need to know by what standards they are to be measured;

- The quantitative impact and calibration of the Internal Ratings Based (IRB) approach and operational risk proposals will need more study and testing;

- Basic standards on loan classification and provisioning should be established to make the capital adequacy standard meaningful;

- External assessments, as well as internal ratings may reinforce adverse market

movements, and may thus generate procyclical effects; also, adverse market movements may lead to higher capital requirements at a time when additional provisions may also be needed;

- More guidance may need to be provided to supervisors to support the three pillars; in this regard, adequate supervisory resources need to be assured, and the need for additional technical support, including external technical assistance, could be made more explicit; and

- While staff strongly supports increased disclosure, this may require changes in the legal framework; this aspect could be emphasized more strongly; the ability of supervisors to verify the reliability of disclosed data, for instance on asset quality, needs to be assured, especially in the absence of internationally convergent provisioning standards. Also, although Staff recognizes the linkages between proper implementations of Pillar 2 on the supervisory review process and Pillar 3 on market discipline, it questions the general assumption that market discipline and banking supervision always reinforce each other.

In addressing these issues and in the interest of simplification and uniform applicability, Fund staff stands ready to work with the BCBS Secretariat on the IRB approach, as well as on loan classification and provisioning, and disclosure standards. Also, it pledges its full support in disseminating, assisting implementation and assessing compliance with the new Accord through its Basel Core Principle assessments, within the Financial Sector Assessment program (FSAP), and in providing technical assistance to help countries implement the new Accord.

I. INTRODUCTION

1. **On January 16, 2001, the Basel Committee on Banking Supervision (BCBS) issued revised proposals for a new capital adequacy framework for banks, incorporating the results of BCBS working groups and numerous comments on the June 1999 consultative documents.** Fund staff appreciates having been given the opportunity to provide its views on the new proposals. The comments provided in this note have been prepared by a working group from the Fund's Monetary and Exchange Affairs, Policy Development and Review, Research, and Statistics Departments, and have benefited from comments by other Fund departments.

2. **The basic architecture of the "three pillar" structure has been retained from the June 1999 proposal but especially Pillars 1 and 3 have been substantially modified since then.** Under Pillar 1 (regulatory capital) the Internal Ratings Based (IRB) approach that uses banks' internal ratings for setting capital adequacy standards has been further developed, as well as a less elaborate "Standardized" approach that uses external rating agency and export credit agency assessments. In addition, specific capital charges for operational risk and asset securitization have been incorporated into the proposals. Pillar 3 provides detailed disclosure requirements on banks' financial condition as well as on their internal risk management systems. Substantial "Supporting Documents" provide detailed explanations and guidance for implementation.

II. GENERAL COMMENTS

3. **Fund staff fully supports the objectives of the BCBS to establish a closer correlation between risk and capital adequacy requirements, and to place more responsibility on the banks to measure their risk, to strengthen the supervisory review process, and to require more substantial disclosure by banks,** including information on asset quality and internal risk management. We also support the incentives in the new proposals for large sophisticated banks to continue to improve their risk management techniques, which can help strengthen the core international banking system. By underscoring banks' obligation to take more responsibility for their own risk management, less reliance on capital adequacy and other prudential regulations, and more on an effective banking supervisory system and market discipline, the proposals considerably broaden the scope of the 1988 Accord.

4. **Although the focus on the limited number of money center banks is essential in view of their systemic importance, the proposals also need to be applicable by all banks in all countries.** As has been communicated to the BCBS by the Fund's Managing Director in a letter dated December 22, 2000, Fund staff is of the view, shared by the staff of the

World Bank and many non-G10 countries, that the new framework should include all banks within its scope, not just "internationally active banks" or "significant" banks. Even the standardized approach under Pillar 1 runs the risk of being too complex for many countries.

5. **As Pillar 1 presents a number of options, for credit risk as well as for operational risk, it may not assure sufficient unity of standards across countries, and could lead to a more uneven rather than a more leveled playing field.** This could make comparisons and assessments of compliance with the standards across countries more difficult and less transparent. Furthermore, countries will grow into the new structure at different speeds, further exacerbating level playing field and comparability difficulties.

6. **These arguments reinforce the need for a simplified, yet no less rigorous, set of standards, to be developed within the new framework that can be implemented by banks and supervisors in all countries.** A simplified approach would facilitate implementation of Pillar 2 and enhance disclosure standards under Pillar 3. Simultaneously, guidance could be developed on loan classification and provisioning, and on valuation of assets, liabilities and contingent liabilities. A simplified approach should also explicitly be suitable for application by domestic banks in G10 countries. The complexity of the proposals should not provide an incentive to opt out of the new system or to continue to apply the 1988 Accord. Remaining outside the new system would take the pressure off banks in all countries to strengthen risk management systems. It would also widen the gap between money center and smaller banks, especially in emerging market countries. Fund staff stands ready to discuss with the Basel Committee Secretariat the outlines of a rigorous simplified approach, which should at the same time retain the most important benefits of the new framework: closer alignment to risk, the judicious use of external assessments, and the elimination of the OECD/non-OECD distinction.

7. **Furthermore, staff is concerned that the proposals appear to overemphasize complex quantitative systems as the best method of managing a bank's risk, and as the focus of supervisory review.** Banks build internal ratings systems primarily for pricing and profit maximization purposes, not to support third party risk assessments or the supervisory process. Staff recommends that the proposals highlight the continued need for good subjective judgment by banks as well as supervisors. The quantitative methodologies, besides saving bank capital, should also address broader prudential concerns. They should also serve as early warning tools for bank management and banking supervision.

8. **The proposals cannot be effective without basic international agreement on standards for loan classification and provisioning, as capital and capital adequacy depend on accurate valuation of banks' assets and liabilities.** Capital should protect against unexpected losses; expected losses are to be covered by specific loan loss provisions. Under provisioning of assets renders capital adequacy measures inaccurate or even meaningless. Any system of loan classification and provisioning, however, should be sufficiently flexible to allow the use of judgment to assess credit risks, and the appropriate level of provisioning. Banks and supervisors remain responsible for adequate risk provisioning, independently of any predetermined template.

9. **More guidance also appears needed on how the proposals are to be applied on a consolidated basis,** domestically and across borders, including banks' cross border-establishments and equity holdings in less sophisticated supervisory jurisdictions. Also in these areas, the proposal could be augmented by additional guidance, or an indication that guidance will be provided by the BCBS in the near future.

III. PILLAR 1

Standardized Approach

10. **The proposed standardized approach is an improvement over the 1988 Accord in that it introduces additional risk buckets, seeks to bring in third party risk assessments and eliminates the outdated OECD rule.** However, it may still be too complex for banks as well as supervisors in many countries, including some major G10 countries, to apply to all banks.

11. **The proposals seek to rely on external rating agencies, yet provides insufficiently precise criteria for the acceptability of such rating agencies, and for limiting supervisory discretion in admitting rating agencies** into the capital adequacy process. The proven accuracy of the ratings should be a key criterion, as well as the use of rigorous back testing techniques, for which only a few rating agencies worldwide have the necessary data. Because rating methodologies can differ and be difficult to reconcile, the proposal could for instance, include a mechanism, anchored in either probability of default or probability of loss, to ensure comparability among ratings within and across countries. Without this mechanism, capital charges could be inconsistent within as well as across countries, depending on the rating agency, and the methodology it applies. Rating methodologies and the 1999 OECD guidelines for country risk assessment by export credit agencies should be disclosed. The use of centralized credit information agencies by many countries could be further explored, as many may have long and useful series on default probabilities.

12. **The proposed reliance on rating agencies or internal ratings, could reinforce the pro-cyclicality of capital requirements inherent in the business and credit cycles. Also, other elements in the supervisory process, such as loan loss provisioning can reinforce the procyclicality of capital requirements**—as was so dramatically demonstrated in the Asian crisis. Methods should be sought to mitigate pro-cyclicality, regardless of its source, for instance by permitting more dynamic provisioning policies. This would imply addressing the accounting issues associated with dynamic provisioning in a way more suitable for the business of banking.

Internal Ratings Based Approach (IRB)

13. **Staff is concerned that the IRB is overly complicated and could pose significant technical problems. As a result, the IRB approach is likely to apply to a very small number of banks in non G10 and even in most G10 countries.** Bank supervisors will

require higher levels of expertise and depth of resources to review banks' internal ratings and operational risk systems on an ongoing basis. The complexity of Pillar 1 may also undermine the effectiveness of Pillars 2 and 3. Only supervisors in a very few countries are likely to be capable of assessing and supervising such complex risk management systems. In most countries, supervisors will not be able to reliably verify the data disclosed under Pillar 3. This reinforces the need for a simplified approach.

14. **The complexity of the proposed IRB does not allow for a thorough assessment in the short timeframe available. The theoretical and technical aspects of the IRB approach presented by the proposals do not provide objective sufficient evidence that it accurately measures credit risk.** For example, the minimum data calibration requirements of five years for Probability of Default and seven years for Loss Given Default may be too short to accurately measure the model's parameters over a full credit cycle. It is also not clear why the minimum sample lengths should differ. Although banks are required to develop appropriate verification schemes, the credit risk exposure estimates associated with this rule will probably not be verifiable with any degree of accuracy. Fund staff is studying these questions and would be pleased to share its conclusions with the BCBS working group dealing with these issues.

15. **Before application, calibration of the IRB approach will require extensive impact studies, which are not likely to be completed before the end of the commenting period.** Also, Pillar 1 seems to be designed so that "unsophisticated" banks that do not apply an IRB approach are taxed with higher capital requirements, regardless of their risk profile and proven risk management abilities. Such aspects could favor or disfavor entire economies and banking systems.

16. **The proposals require rigorous verification schemes, yet provide insufficient guidance on the verification process**; such systems depend heavily on good quality data input from the banks. Weaknesses in verification will seriously compromise the effectiveness of Pillar 3.

17. **Also the IRB approach can have procyclical effects, as higher capital requirements based on macroeconomic considerations could for instance coincide with deteriorating risk ratings** and the associated higher capital requirements.

18. **The proposals may lead to a number of other unintended effects.** The incentives to use the IRB approach could lead banks to focus on the better credits, thus leaving the poorer risks to non-IRB banks, less well-regulated jurisdictions, and thus reinforcing market segmentation. Also, by not rating poor risk corporate loans, a relatively more favorable weighting can be obtained.

19. **The approach to credit risk of OTC derivatives could be developed further, in particular the proposed add-ons for potential future exposure,** which would be used both in the standardized and IRB approaches. The proposals significantly improve the capital implications of credit risk mitigation techniques, such as collateral, netting, guarantees and

credit derivatives. The current treatment of credit risk in OTC derivatives, however, would largely remain unchanged both in the standardized and the IRB approaches. In light of the increasing sophistication of banks in pricing OTC derivatives and arbitraging capital charges, fixed add-on factors may not capture the dynamic nature of OTC derivatives exposures. More flexible and accurate approaches could be considered. In this context, we welcome the Committee's plans to evaluate whether banks—within the IRB framework, and subject to sound practice requirements—could be allowed to use their own estimates of potential future exposures as a basis for capital charges on OTC derivatives.

20. **Although the proposals for systematic review of operational risk by banks and supervisors deserve support, the proposal for capital charges against this type of risk still contains many loose ends.** The proposed system would imply extensive and costly data collection and analysis capabilities. The proposals on operational risk will therefore not be applicable in the great majority of banking systems. Even when further work has been completed, only the "basic indicator" proposal will be suitable for all banks in all countries. Therefore, consideration should be given to an approach, which develops a middle position between the "basic indicator" approach based on a flat percentage of gross income, and the more sophisticated systems elaborated in the proposals, for instance by using a breakdown of the components of operational risk which reflects more closely market realities in emerging markets.

IV. PILLAR 2

21. **Fund staff strongly supports the emphasis the proposals place on the supervisory review process.** However, this places substantial additional demands on bank supervisors. Consideration could be given in this context to requiring fees from banks to help fund the monitoring of the more complex supervisory approaches, at the same time avoiding disincentives to develop IRB systems.

22. **Additional guidance to supervisors on how to assess the robustness of banks' risk management systems and the quality of rating agencies should be provided under Pillar 1.** Pillar 2 would also need provisions on how supervisors are held accountable, in light of their much-increased responsibility and discretion. There is also a need for better cross border coordination and cooperation between supervisors.

23. **The proposals should also place more emphasis on the option of assigning higher capital adequacy ratios for individual banks with higher risk profiles, as well as across sectors in countries with a relatively high risk-banking environment.**

V. PILLAR 3

24. **Fund staff strongly supports the public disclosure and market discipline strategy contained in the new Accord, even if collecting and disclosing the required information**

will be a major task for many banks. On the other hand, staff has concerns that market discipline could react precipitously, in ways that run contrary to supervisory concerns for market stability and confidence in financial institutions. Given its extensive experience in initiatives to promote the dissemination and disclosure of data, Fund staff stands ready to work with national authorities to implement the disclosures recommended under Pillar 3.

25. **Disclosure requirements need to be designed in a way that allows institutions to efficiently collect the data and publish it in a transparent way.** Also, supervisors need sufficiently robust loan classification and provisioning and accounting rules to verify the data disclosed. They need to be sufficiently equipped to verify the accuracy of the disclosed information. The absence of these systems could lead to the disclosure of unreliable data. Furthermore, the document seems to base the distinction between required disclosure and "strongly recommended disclosure" on the possibly insufficiently strong legal basis for the supervisors to require such disclosure. If that is the case, it should recommend that countries strengthen their legal basis for disclosure.

26. **The Fund's survey of the macro-prudential indicators, but also supervisory practice shows that supervisors, analysts and the private sector prefer quarterly disclosure of banking information, rather than semi-annually.**[1] Disclosure should also cover bank profitability, foreign currency exposures, and real estate exposure (disaggregated between commercial and residential). Most such data are already collected by banks, and are highly relevant for an outside assessment of a bank's financial strength and risk profile. Furthermore, Staff would recommend that wherever appropriate, the new Accord should advocate the use of existing national accounts classification systems for financial sectors, financial instruments and residency criteria (see for instance the Fund's System of National Accounts 1993, the IMF Balance of Payments Manual, and the IMF Monetary and Financial Statistics Manual). Using standardized formats would greatly leverage the usefulness of the data, and facilitate analytical linkages of banking data with macroeconomic statistics.

27. **In connection with the requirement to disclose data on capital and capital adequacy, there is a need for greater uniformity in defining the components of the numerator of the capital adequacy ratio,** as staff remarked in its comments to the initial consultative documents. Without such uniformity of criteria and calculations and

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[1] Our disclosure recommendations reflect the results of the survey of macroprudential indicators in which responses were received from over two-thirds of IMF member countries regarding official and private sector uses of macroprudential information. Those recommendations also correspond closely with those in the Bank of England 1999 study "Financial Market Data for International Financial Stability" which stated (p 12): "Given the importance users attribute to indicators of banking health, we recommend that national supervisory agencies publish, on a quarterly frequency, key indicators of capital adequacy, non-performing loans, liquidity and profitability at aggregate and peer group level."

comparability of capital eligibility, capital adequacy figures may be inaccurate, and aggregation and international comparability meaningless. The use of standardized, internet compatible templates with standard coding for disclosure under Pillar 3 would enhance the usefulness of the data.

28. **It is important that the disclosure requirements of Pillar 3 are not watered down in response to industry concerns.** Making the requirements narrower or less prescriptive could undermine the effectiveness of the proposals, which rely on a combination of forces of the banks, their supervisors, and the markets.

VI. Implementation Issues

29. **More guidance needs to be provided, in the proposals themselves, as well as in the form of technical support to supervisors** around the globe, to ensure that these proposals are implemented successfully. We presume that such support would be provided through the Financial Stability Institute as well as through IMF and World Bank. Fund staff pledges its full support in the dissemination and propagation of the new accord in the course of its country work.

30. **Finally, the quality of the implementation of the new Capital Accord will need to be monitored and assessed periodically**. The Fund envisages playing a major role in the context of the joint IMF-World Bank Financial Sector Assessment Program and in the course of its technical assistance. There will clearly be a need to revise the Core Principles for Effective Banking Supervision and to develop new assessment methods and criteria that fully reflect the new proposals. We look forward to working closely with the BCBS in all these aspects of the implementation of the proposals.