**IOSCO COMMENTS ON THE NEW BASEL CAPITAL ACCORD (PUBLISHED JANUARY 2001)**

**Introduction**

1 IOSCO is very pleased to have the opportunity to comment on the new Basel Capital Accord as set out in the second consultative package of January 2001. As noted in our comments on the first consultative package, whilst banking and securities regulators have traditionally taken somewhat different approaches to the regulation of capital and liquidity there has, in recent years, been an increasing overlap between the activities of banks and securities firms. This means that IOSCO members have both a considerable body of relevant practical experience on which to draw in commenting on the Capital Accord and a strong operational interest in ensuring that it is well thought through and implemented.

2 In this spirit, IOSCO has considered the Accord from three perspectives:

- whether IOSCO is able to offer insights based on the experience of securities regulators
- whether, in the view of IOSCO, the principles underlying the Accord appear sound and workable
- whether the Accord, if implemented in the proposed form, would create problems for securities regulators (for example by creating weaknesses in the financial system overall, incentives for regulatory arbitrage, competitive inequalities or perverse market incentives).

3 A key area of concern in the first consultative package was the proposal that a jurisdiction's adoption, and progress towards implementation, of the IOSCO's Objectives and Principles should be regarded as a necessary (but not sufficient) condition for securities firms in that jurisdiction to attract a capital weighting of less than 100%. The recognition of the Objectives and Principles in this proposal was welcome but its removal from the latest version of the Accord eliminates a number of serious practical difficulties of implementation.

4 We note the provision in the new Accord that claims on securities firms may be treated as claims on banks provided certain conditions are met. In several jurisdictions, capital requirements for securities firms are set on a basis which differs markedly from that for banks which is proposed in the new Accord. This does not mean that the procedures are necessarily less rigorous or that they cannot be characterised as risk based. While we understand the rationale for this provision, therefore, its implementation could create a number of practical difficulties and involve difficult judgements on the part of banking supervisors.

**First pillar: minimum regulatory capital requirements**

***Tiered credit risk weights***

5 IOSCO supports the proposal to tier risk weights for credit risk according to the external or internal credit rating of the counterparty. This approach is consistent with that taken by the SEC in the United States where it has permitted a reduction in capital requirements in a prudent manner for counterparties with strong credit ratings.

6 We do, however, note the proposal that the risk weights for counterparties with credit ratings below B- should be 150%, which is greater than the weighting of 100% proposed for unrated counterparties. This would appear to create a perverse incentive for counterparties to remain unrated, or for financial institutions to elect not to rate counterparties which would otherwise receive the higher capital charge. This provision may therefore need some clarification.

***Central counterparties***

7 The Accord does not appear to consider risk exposures to central counterparties, such as clearing houses for futures exchanges. These act as counterparty to each transaction on the exchange for which they clear contracts. Banks routinely trade futures contracts on organised exchanges and post margin in the form of cash and securities. They therefore typically have significant credit exposures to such clearing houses.

8 Similarly, the Accord does not address the credit risk of OTC clearing houses, the use of which is increasing and is likely to continue to do so in future.

9 The Basel Committee and IOSCO have recognised that central counterparties can, in the event of failure, be a source of systemic risk. Accordingly, they need to have rigorous risk management procedures, the capacity to absorb losses and the legal basis for netting and financial support arrangements needs to be transparent and enforceable[1]

10 We would therefore welcome an explicit recognition in the Accord of the risks embodied in dealings with central counterparties. Such dealings involve credit risks but, where the central counterparties are well managed and regulated, they have the effect of greatly reducing credit risk overall. There would therefore seem to be scope for a differentiated capital treatment of such transactions, with regulated counterparties having demonstrably sound risk management arrangements attracting relatively favourable capital weightings.

***Use of external credit assessments***

11 The rationale for considering the use of external credit assessments as a means of distinguishing among credit risks is clearly spelled out in the consultative package. External credit assessments are used by the SEC in the United States where capital requirements for broker dealers are dependent in part on the credit quality of the debt securities they hold, as measured by ratings provided by nationally recognised statistical ratings organisations (NRSROs). In designating a rating organisation an NRSRO, the SEC takes into account many of the same criteria as those proposed in the Accord for the recognition of eligible external credit assessment institutions.

12 The most important factor used by the SEC, however, is national market recognition, in the sense that the rating organisation is generally recognised in the US as an issuer of credible and reliable ratings by the predominant users of securities ratings. Such a market based test obviates the need for the regulator to find itself in the difficult position of, in effect, granting the ratings agency a

[1] Recommendations for Securities Settlement Systems: Report of the Committee on Payment and Settlement Systems and the IOSCO Task Force on Securities Settlement Systems, January 2001.

business franchise.  The existence of the franchise is itself a precondition of recognition so that, in the US, the marketplace is relied upon previously to have judged the credibility or the institution's ratings.  Based on its experience, the SEC has found that this approach has generally worked well, though ratings agencies are of course fallible.

13 IOSCO agrees that safeguards, in the form of possession of a track record and other rigorous selection procedures are of paramount importance in ensuring the integrity of agencies' ratings.  In most countries, however, ratings agencies are less well established than in the US and their coverage, in terms of numbers of institutions rated, is considerably narrower.  This means that neither an existing market franchise nor the disciplines of an established marketplace may exist.  This poses two main risks:

- regulators may find themselves in the undesirable position of having to vet and approve ratings agencies; and/or

- ratings agencies may be recognised even though their assessments are questionable.  This could have the effect of undermining well established agencies, with adverse consequences for regulators already making use of this approach.

***Collateral***

14 The new proposed Accord recognises a much wider range of collateral as eligible than is currently the case.  IOSCO supports the principle that capital requirements should be reduced to the extent that banks have eligible liquid collateral to secure assets.  The increase in the range of eligible collateral, while welcome, will however place further emphasis on the need for sound collateral management.  This includes the application of appropriate haircuts, daily marking of collateral to market and stress testing.  It also needs to be recognised that collateral management itself incurs a certain level of operational risk which needs to be managed carefully.

15 The new Accord may impose a significant minimum charge on claims that are fully secured by liquid securities other than government securities.  It is

perhaps worth noting here that many securities regulators do not require a comparable minimum charge for liquid collateral that is marked to market daily. The experience of such regulators is that securities firms having such collateralised exposures have not suffered significant losses.

***Internal ratings***

16 With the limitations on the global use of external ratings noted above, IOSCO agrees that greater reliance on banks' internal ratings is likely to be a more practicable way of achieving greater differentiation of many banks' credit risks in the near future. We therefore agree that this approach should be developed further. We would attach particular importance to the need, recognised in the consultative paper, for the the development of quantitative and qualitative standards for use by supervisors in recognising, validating and monitoring banks' internal rating systems. Such standards are needed to protect against any unwarranted erosion of credit standards as a result of the use of internal ratings. The approach adopted also needs to be sufficiently flexible, however, not restrict the ability of individual firms to develop credit risk management systems which are attuned to their particular business needs and organisation.

***Credit risk models***

17 IOSCO shares the view of the Basel Committee that the development and refinement of credit risk models for risk management purposes is something which should be encouraged by regulators of all financial institutions which incur credit risk. Although securities firms incur little credit risk through conventional lending, such risk is embodied in much of their mainstream activity such as repo and OTC derivatives transactions.

18 IOSCO also shares the overall conclusion of the Basel Committee that significant hurdles need to be overcome before the use of such models as the basis for calculating capital requirements can be contemplated. The conceptual and practical issues involved may well prove greater than those associated with models for estimating market risk. Were regulators to conclude at some future point that sufficient progress had been made to enable

such models to be used as the basis of capital calculation, this would certainly need to be subject to restrictions on their use and the implementation of capital buffers at least as rigorous as those which currently apply to the use of market risk models.

***Operational risk***

19 IOSCO members have a close interest in the development of measures of operational risk as a basis for setting capital charges. We welcome the efforts under way to develop an all-encompassing framework intended systematically to address operational risk alongside market and credit risk in bank and securities firms.

20 Variants of the basic indicator approach are already in use by securities regulators. Minimum capital charges in some countries are based on measures of the amount of business conducted across broad ranges of activity, such as receivables from customers. An alternative approach is to impose capital requirements based on identified failures in firms' operations. In the US, for example, firms are required to conduct quarterly box counts of securities in the firm's possession and capital charges are imposed on the basis of any shortfalls arising from these counts.

21 IOSCO has a particular interest in the development of the standard approach for two reasons:

- the operational risk charge applied to banks will have competitive implications for securities firms
- the framework adopted in the new Accord is likely to form the basis of a European directive which will govern the setting of capital charges for securities firms incorporated in Europe.

22 It is therefore particularly important that the approach adopted for banks accurately captures operational risk. This depends on the identification of a representative set of business lines, the quantification of these and the application of risk weights which accurately reflect the likelihood of loss.

23 IOSCO recognises that the development and calibration of the standard approach is a very considerable challenge, not least because of the paucity of comparable historic loss data. IOSCO has offerred to assist in the process by means of a dialogue with the Basel Committee and the collection, on a best efforts basis, of loss data from securities firms. This offer has been taken up and we look forward to collaborating on this important issue.

24 We would expect it to be some time before it is possible to contemplate using an internal measurement approach for the calculation of an operational risk charge. If and when this point is reached, we would expect this to be subject to a number of safeguards similar to those applied to the use of internal models for assessing credit risk (paragraph 18 above).

**Second pillar: Supervisory Review**

25 IOSCO agrees that the total level of risk assumed by financial institutions, comprising business and control risks, is the appropriate basis for setting regulatory capital as well as being the basis on which prudent firms calculate their economic capital. No standard framework for the calculation of capital will be able to reflect the totality of these risks.

26 IOSCO welcomes the approach set out in the second pillar. This is consistent with our views on regulatory standards and is a step towards more effective regulation of financial institutions. Regulators have to be aware of the risk profile of individual institutions and to adapt capital and risk control requirements on that basis.

27 The approach of securities regulators to these issues has been to require additional buffers above minimum capital requirements. If capital falls below this level, regulators will review the situation of the firm and generally require prompt remedial action. In addition to the restoration of an appropriate level of capital such actions may also include more intensive or frequent reporting to the regulator and strengthening of control processes. It should also be noted in this context that in many cases the market itself has required firms to maintain capital levels above those required by regulators, resulting in effect in a capital buffer.

28 The supervisory review process requires supervisors to evaluate how well banks are able to assess their capital adequacy needs relative to their risks. These internal processes would then be subject to supervisory review and intervention where appropriate. IOSCO is doubtful whether it would be feasible to apply the level of flexibility implied by this approach to a group as heterogeneous as securities firms. There is a concern among some securities regulators that the absence of a completely transparent methodology for determining capital requirements on a case by case basis would leave them subject to challenge from the firms under review. There are also concerns that such an approach may invite charges that regulators are creating competitive disparities through the setting of capital charges on the basis of firm-by-firm review.

29 IOSCO does not, on balance, believe that the adoption of a supervisory review process by banking supervisors will create insuperable problems of regulatory arbitrage or competitive disparity. Securities regulators will, however, remain alert to this possibility and, as part of its dialogue with the Basel Committee, IOSCO will draw attention to any such problems which may arise in future.

**Third pillar: market discipline**

30 IOSCO agrees that disclosure has an important role in allowing participants in financial markets accurately to assess risks and returns, and hence in bolstering market discipline. Timely information about the nature and effectiveness of firms' own risk management processes is an important aspect of this.

31 We therefore support the principles underlying the third pillar. IOSCO participated actively (alongside the Basel Committee, CGFS and IAIS) in the Multidisciplinary Working Group on Enhanced Disclosure. The Basel Committee will wish to take account of the work of that group in formulating disclosure requirements for banks. The disclosure rules which emerge from the Basel process will be of considerable importance to securities firms. They will play a large part in establishing broader market standards for disclosure and, to the extent that they come to be reflected in European directives, will be

directly applicable to securities firms in Europe. IOSCO therefore wishes to maintain a close dialogue with the Basel Committee to assess the likely implications of disclosure requirements for securities firms. IOSCO and the Basel Committee may also need to collaborate to ensure that the catalogue of disclosure items which emerges as part of Pillar three is appropriate to a broad range of financial institutions.