KREDITTILSYNET **NORGES BANK**

RESPONSE TO THE BASEL COMMETEE'S CONSULTATIVE DOCUMENT – THE NEW BASEL ACCORD

This consultative statement was prepared jointly by Norges Bank and Banking, Insurance and Securities Commission of Norway (Kredittilsynet). It includes views submitted by Norwegian banking organisations. Attached are copies of the statements from The Financial Services Association of Norway (FNH) and The Norwegian Savingsbanks Association.

1. GENERAL OBSERVATIONS

Norges Bank and Kredittilsynet are in favour of a revision being carried out of the current capital adequacy rules, so that the regulatory framework to a greater extent reflects the relationship between the capital requirement and the bank's economic risk. The proposal will provide incentives towards a continuous improvement of banks' internal systems for measuring and controlling risks. Norges Bank and Kredittilsynet support the proposal from the Basel Committee that the regulatory framework should be founded on a so-called "evolutionary approach". This entails that, upon recognition from the supervisory authorities, banks may choose different methods for calculating the capital requirements, depending on the complexity of the activities, and the quality of the risk management. The New Basel Capital Accord will, nevertheless, represent a reform so far-reaching and complicated that it is difficult at the present time to know all its effects. It will therefore also be important in future years to have both active follow-up on the implementation of the new regime, and a continual evaluation of its consequences. The New Basel Capital Accord will mean increasing demands as to qualifications and resources within the supervisory authorities and to some extent within institutions.

The need for harmonised international standards

It is of decisive importance to reach broad agreement concerning the capital adequacy guidelines. It is, furthermore, altogether central to ensure a responsible level for the capital adequacy. Dissimilar rules in the various countries may give rise to " supervisory arbitrage" with credit institutions deciding to set up in countries which have the most liberal regulatory framework. As the mobility of capital increases, it is important to have common rules in order to ensure stability. The combination of increasingly mobile capital, cross-border activities, and the effect of a general deterioration of capital adequacy resulting from weakning of capital requirements will heighten the risk of contagion effects spreading across national borders.

The introduction of the second pillar, the supervisory review process, will increase the need for greater harmonisation of international supervisory practices to ensure a level playing field among banks across borders.

Complexity and competitive conditions

Taken altogether The New Basel Capital Accord entails a regulatory framework substantially more complicated and comprehensive than the current Capital Accord. The complexity may partly be justified as the new framework can be seen as a reflection of the advancement and

innovations in the financial market place and the need for a more risk-sensitive framework. A complex framework containing a series of options for implementation could easily breach the basic principle of a level playing field. Moreover, a complicated regime could mean that only a few persons employed by institutions and the supervisory authorities are familiar with the rules and with key factors bearing on the individual institution`s capital adequacy.

The proposal for a revised capital accord also means that the need for a revision of the numerator in the capital adequacy ratio will become more urgent. In our view the current framework entail an overly complex capital structure in institutions. A hierarchy of instruments in an institutions capital base could impede a speedy solution of an acute solvency problem. The main emphasis should be on the tier one capital / core capital which will constitute a *de facto* buffer in an emergency situation.

Calibrating the capital adequacy requirement
The remaining work as regards calibration of the various elements of the proposal from the Basel Committee, in the light of the outcome from the Quantitative Impact Study etc., will be of decisive significance to the final proposal from the Committee. In co-operation with FNH and Sparebankforeningen, Norges Bank and Kredittilsynet have conducted a survey of the impact of the standardised approach on a selected group of Norwegian banks. The outcome of this survey has been set out in paragraph 6. This survey shows that the capital adequacy requirement for operational risk contributes to a significant increase in the total requirement for the participated banks. In Norges Bank and Kredittilsynet point of view, this should be considered when calibrating the system.

The banking industry in Norway and in several other European countries has not been sufficiently robust to avoid a banking crisis. Norges Bank and Kredittilsynet support the intention of the Basel Committee that the overall solvency in the banking system should not be reduced as a result of the proposed reforms. Nevertheless, in practice the danger exists that the level of overall capital will be reduced as major financial groups will achieve a lower capital requirement. In the event that the released capital in these groups is used to make acquisitions of other banks, the level of overall capital could be reduced.

Any objective that the size of overall capital should remain unaltered will necessarily have to be based on an average consideration. This entails that for some institutions the total capital adequacy requirement might be higher or lower than under the current requirements. Banks intending to apply internal ratings to portfolios of high quality and who have well documented credit control procedures should, according to the intention of the Basel Committee, be subject to a capital adequacy requirement lower than under the standard method. An internal ratings based approach will, on the other hand, result in a stricter requirement for banks where the quality of the credit portfolios is poor. Those banks will, therefore, apply the standardised approach in calculating the capital adequacy requirement. In order to ensure transparency, as laid down in the third pillar, and consistency with the standardised approach, banks who apply internal ratings should also publish their capital ratio as based on the standard method. To ensure satisfactory monitoring of the banking and financial system in its entirety, calculations ought to be made according to the standardised approach at least twice annually for a transitional period. Also in the longer term for monitoring reasons, one should consider having annual calculations. A corresponding view is held by Sparebankforeningen.

Altered methodology of supervision
Norges Bank and Kredittilsynet would point out that the second pillar entails a substantial change in supervisory methods. The proposal will mean that the supervisory authorities will be taking a more active role in evaluating and recognising the risk management systems used by the banks, as well as assessing the overall risk, the level of the capital adequacy, and the access to intervene. It must nevertheless be clear that it is the management and the owners of the bank who are responsible for proper risk management and for taking appropriate action if and when problems arise.

Pro-cyclicality
It is currently being debated whether the capital adequacy rules have the effect of being pro-cyclical and whether the new framework will enhance the sensitivity of capital requirements to the economic cycle, hence reinforcing the tendency of banks to act in a pro-cyclical manner. One important prerequisite for avoiding any such effects is that the rating systems used by banks are based on credit assessments of a more forward-looking nature that are well anchored in sufficiently long records of loss experience. In more general terms it is important to emphasise the time-dimension associated with evaluations of risk and the way the risk picture varies over time. Although one cannot in an economic upswing time precisely estimate when the downturn will occur, all experience warrants that it will indeed come, and that losses will normally rise. In principle, therefore, financial strength should be built up during times of economic expansion when bank profits are sound and loan losses are low.

In general it may often be the case that risk is underestimated in times of economic boom and overestimated in times of recession. This may be a significant reason why banks act pro-cyclically, and it underlines why the time-dimension related to risk is so important. To contribute to a situation where risk assessments are based on a forward-looking and long-term perspective, is a more general challenge which will concern both banks and the supervisory authorities in applying the new system. The question of pro-cyclicality must also be viewed in the context of how the regulatory framework for loan loss provisions has been designed. In future it will be important that the Basel Committee continues its work of analysing possible pro-cyclical effects of the new capital adequacy regime. One should also consider how the regulatory framework for loan loss provisioning might most appropriately be designed in order to abate such unfortunate effects.

Market discipline
The third pillar, market discipline, represent an important part of the totality of the new aggregate system for capital adequacy. Measures to ensure both increased transparency and harmonisation of standards for external reporting are important in order for market disciplinary mechanisms to function. Greater transparency and access to information about the capital and risk exposures of banks will not least be of major significance when a capital adequacy system is in place which is considerably more complicated and comprehensive.

Implementation time and consultation deadline
The New Basel Capital Accord will mean increasing demands as to qualifications and resources both within institutions and with the supervisory authorities. The short implementation deadline set in 2004 will mean that both banks and the supervisory authorities will be facing great challenges.

FNH is of the opinion that both the scope of the proposals and the major changes being proposed in the regulatory framework of the new Basel Accord, will mean that preparing

comments will be time consuming. In view of this it would seem that the time period for presenting remarks is too short.

2. SCOPE OF APPLICATION

The Basel Committee proposes a widening of the definition of institutions to be included in the consolidation so as to apply also to securities firms and bank holding companies. Norges Bank and Kredittilsynet support this proposal. Securities firms and banks compete to some extent within the same markets and will largely be exposed to similar risks. Consolidation of holding companies will provide a more correct picture of overall risk exposure while reducing the extent of debt-financed capital in subsidiaries/ associated companies.

We furthermore endorse the Committee's proposal that the capital requirement must be complied with both at company level, at sub-group level and at group level. The consolidation provisions will thus help ensure that the capital is being allocated in proportion to the degree of risk in various parts of the group. This will be necessary to avoid contagion effects within financial conglomerates.

Norges Bank and Kredittilsynet support the Committee's proposal for full consolidation of a subsidiary which is a credit institution or a securities enterprise. With regard to the treatment of minority interests, we are, however, of the opinion that a deduction should be made from the capital of the group for the share of the minority interests in any surplus of total capital in a subsidiary beyond the minimum requirement.

The Committee also proposes that until further notice a deduction shall be made from the total capital for a subsidiary which is an insurance company. In Norway the requirements as to capital adequacy for credit institutions and securities firms have also been made applicable to insurance companies, at company as well as at group level. We take a positive view of continuing the work to develop capital standards for financial conglomerates. The trend which entails that a financial services group is no longer made up exclusively of banks, and the overlapping of activities in banking and insurance, will increase the need for supervision of mixed groups.

3. THE FIRST PILLAR – MINIMUM CAPITAL REQUIREMENTS

3.1 The Standardised Approach

The standardised approach as it is presented in The New Basel Capital Accord, is founded on the same principles as the current capital requirement for credit risk. The most significant changes proposed are the possibility of using external ratings of counterparts for the purpose of determining risk weighting on claims.

It is furthermore proposed in The New Basel Capital Accord to introduce a new risk weighting of 150 per cent for those assets with the lowest rating, as well as for non-performing loans. Non-rated counterparts will as a main rule be given a weighting of 100 per cent. We would note that as far as those counterparts are concerned to whom the highest risk attaches, there will be a definite incentive to avoid being rated so long as they are able to obtain a lower risk weighting by not being rated. This must be deemed an unfortunate aspect of the proposal. Norges Bank and Kredittilsynet are, however, in favour of the proposal that

non-performing assets be given a risk weighting of 150 per cent for any part exceeding any loan loss provision made against the commitment.

Norges Bank and Kredittilsynet are nevertheless of the opinion that it will be necessary to retain the standardised approach as an alternative for the banks. Many smaller banks will have neither the need for, nor be in a position to avail themselves of neither the simplified nor the more sophisticated version of internal rating. This should be viewed against the type of business conducted by these banks, and that many of these banks already maintain a high level of capital adequacy.

Weighting of claims on banks
Norges Bank and Kredittilsynet would point out that banks are subject to supervision, to capital requirements and to an underlying safety-net, something which taken together might justify a lower weighting for banks than for other commercial activities. There are two proposals for the weighting of claims on banks in The New Basel Capital Accord:

1. Claims on banks are given a risk weighting corresponding to one risk category above the risk class pertaining to the sovereign. There is a cap of 100 per cent weighting, with the exception of banks in countries with the weakest rating. For these banks the risk weight is set at 150 per cent.
2. The risk class is commensurate with the bank's individual rating, yet can never be below the risk class of the country where it is domiciled. Non-rated banks are given a risk weighting of 50 per cent.

One weakness of the alternative 1 is that it punishes the best banks while the weaker ones fare relatively better. Besides, that alternative will not offer any incentive for banks to further develop their risk management.

Although alternative 1 is not in accordance with the principles of risk based weightings there are considerable disadvantages to small countries with small banks under alternative 2. These banks will only to a minor extent be rated and will thus be allocated a risk weighting of 50 per cent. Furthermore this method can be justified since there is a close relationship between the country's economic situation and the credit-worthiness of its banks. Against this, Norges Bank and Kredittilsynet support alternative 1 which will entail that banks are allocated risk weightings according to the country's risk class. FNH and Sparebankforeningen also lend their support to that alternative.

The alternative 2 would allow claims with a maturity of three months or less to be given a lower risk weighting. Norwegian banks make use of borrowing at up to six months term in the interbank market. FNH and Sparebankforeningen are of the opinion that specifying the limit for short-term claims as a maturity of three months will offer strong incentives for banks to use shorter term funding. This will contribute towards a higher liquidity risk in banks. Norges Bank and Kredittilsynet endorse these points of view.

Weighting of claims secured by commercial property
As far as loans secured by commercial property are concerned, the Basel Committee points to that in many countries loan losses over time have been substantial, so that having a risk weighting of less than 100 per cent cannot be justified. Norges Bank and Kredittilsynet share that opinion. Norwegian experience has also shown that the risk of loss related to such commitments is considerable, hence a risk weighting of 100 per cent should be applied.

Recognition of rating agencies
Using external ratings of counterparts in determining the risk weighting could mean that capital requirements become more sensitive to risk. The proposal furthermore provides opportunities for the supervisory authorities in the individual countries to allow the use of so-called "unsolicited ratings" along the same lines as "solicited ratings". A number of countries, however, have established neither rating agencies nor "unsolicited ratings". In particular where many smaller banks in such countries are concerned, very few of their counterparts will possess a rating, and the change compared with the existing regulatory framework will therefore not be significant. These banks will, moreover, suffer a competitive disadvantage vis-á-vis countries where rating is more widespread, since they will need to allocate a risk weighting of 100 per cent to corporate claims.

The advantage of allowing "unsolicited ratings" to be recognised is that a larger number of commitments can be given a risk weighting based on external rating. It is, however, of the utmost importance to impose very strict requirements on these companies, for instance with regard to the quality of the data and methods which form the basis for the rating.

3.2 The internal rating based approach
Norges Bank and Kredittilsynet take a positive view of allowing banks' internal rating systems to be used because this will contribute to a closer relationship between the capital requirement and the actual risk inherent in the portfolio of each institution. The proposal will furthermore contribute to making banks more competitive in providing finance to large and sound enterprises. A possible lowering of the capital requirement for exposures towards these will assist in making financing through banks a real alternative to borrowing directly in financial markets for such enterprises.

The proposal goes far in providing useful guidelines with a view to implementation. Also in this respect it will be important to exercise the second pillar. Should the supervisory authorities find that a financial institution has a portfolio composition with risk elements that deviate clearly from what has formed the basis for calibrating the capital requirement, then the consequence should be a higher individual capital requirement.

The length of data series
The Basel Committee has posed a minimum requirement as to the length of the historical material for calculating the "Probability of Default" (PD) of 5 years. Norges Bank and Kredittilsynet would point out that 5 years appear to be rather a short time for capturing fluctuations across the economic cycle. Ideally one should therefore have longer time series in order to calculate credit risk. If Norwegian banks had taken the previous 5 years as their basis in estimating credit risk, the capital adequacy would probably have been too low, because during that period of time Norway's economy has largely been marked by economic expansion and small credit losses. Like the Basel Committee Norges Bank and Kredittilsynet hold that banks will need to use conservative assumptions and assessments in adapting the elements which form part of the internal ratings systems in banks.

Norges Bank and Kredittilsynet would emphasise that a conservative emphasis will be particularly important if the historical material has a relatively short span. For banks as well as the supervisory authorities it will be an important task to ensure that such a conservative approach will be adopted as the basis for evaluating risk. Norges Bank and Kredittilsynet

would emphasise how important it is that banks should be requested to complete necessary stress tests for the purpose of assessing the impact of unforeseen events.

Taking as the basis an evaluation of the fact that the historical material which is to become part of the banks' rating systems will not be completely satisfactory, it is moreover of significance to assess how important the requirement as to historical depth is as compared with the other requirements made of internal rating systems. To apply an internal rating system will for instance require that it must be possible to divide the portfolio into classes both by customer category and risk, and that no risk class (grade) within one single customer category may have a proportion of more than 30 per cent of the total exposure for that customer category. It is a further requirement that the internal rating must at regular intervals be subjected to reviews and re-evaluation by an independent body. The minimum requirement as regards the time horizon for estimating the probability of default is 12 months. Weighing the various requirements against each other will, as viewed by Norges Bank and Kredittilsynet, also be of significance as to when Norwegian banks may start using internal rating systems in calculating their capital requirement.

Definition of default

The Basel Committee outlines four different alternative occurrences as definition of a "default" situation. Norges Bank and Kredittilsynet are of the opinion that these are events which are mainly practised today in evaluating the probability of default. It is nevertheless the point of view that the definitions outlined are not necessarily sufficiently clear and unambiguous to ensure common standards and a common understanding of the concept among institutions. This is also important from the point of view of the supervisory authorities whose responsibility is to approve each bank's "PDs".

Maturity

It has been proposed in the new Capital Accord that maturity should be one of the parameters included when calculating the capital requirement. The probability of insolvency increases with the length of the time horizon. A capital requirement which reflects this fact is therefore, in the opinion of Norges Bank and Kredittilsynet, well justified and consistent with the objective to tie the capital requirement with actual risk.

When using the "Foundation Approach" the Basel Committee proposes that the effective maturity should be set at three years for all types of loan. Norges Bank and Kredittilsynet have no view as to whether three years is a correct estimate, or whether applying this estimate could contribute in changing bank's behaviour as regards the maturity of the portfolios within the various categories. It is furthermore the opinion that the average maturity in a credit portfolio might increase considerably in an emergency situation. Consequently, the requirements as to maturity should to the greatest extent possible be tied to real maturities, as the requirement is when using the "Advanced Approach". Banks' calculations must, however, be presumed to be adequately documented so that disloyal adaptations to the regulatory framework may as far as possible be averted.

Segmentation

Within the "Retail-market" the Basel document contains several proposals for segmentation. Norges Bank and Kredittilsynet have no particular comments on the proposal, but the opinion is that segmentation according to type of product or type of debtor (using scoring systems) is what has so far been the most relevant. Developments both as regards products and systems will, however, mean that the segmentation will constantly need to be changed.

Expected and unexpected losess
The capital adequacy requirement for the IRB approach has been calibrated on the basis of Probability of Default (PD) in the various risk categories, and under an assumption of Loss Given Default. It has been taken as a further basis that the variance in "PD"-values remains constant across all risk categories, a fact which may prove to deviate from the actual state of affairs in various countries and market areas. The calibration has also been based on an assumption of an average remaining maturity of loans of three years.

Equity capital should cater for losses beyond expected losses. By relying on expected losses when determining the capital requirement, one can argue that there is an inclusion in the calculations elements which may be covered by operating earnings which will consequently not be charged against the equity capital. The calculations may therefore result in a capital requirement slightly too high. Experience nevertheless warrants that the regulatory framework concerning loan loss provisions in many countries are not designed in a way which adequately capture expected losses. It may also be the case that banks have insufficient risk pricing so that margin mark ups to cover expected losses are not being carried out in full. Under those conditions it will be more likely that banks will need to charge the equity capital in years with negative results. This would warrant a conservative calibration of the capital requirement. An additional argument in favour of a conservative approach is that many countries permit banks to include in the total capital reserves allocations which have the character of being provisions for expected losses.

Requirements for recognition of internal rating
Recognition of internal rating systems entails, among other things, ensuring that the quantitative and qualitative requirements have been met. In our view it is important to emphasise that model analytics only represents <u>one</u> part of the recognition process. It is furthermore important to ensure that the rating system covers the business areas of the institution, and that it captures the risk associated with those business areas.

Equally cardinal to the recognition procedure will be to review and evaluate the control environment surrounding the model, and to establish an understanding of the risk inherent in the activities comprised by the model. An important part of the recognition procedure will be to ensure that rating systems form an integral part of the credit assessment process and the internal risk management with implications for the pricing of individual credits and the composition of the lending portfolio.

3.3 Credit Risk Mitigation (CRM)
One objection to the current Capital Accord is that only to a limited extent does it consider the use of risk mitigation techniques in calculations of capital requirements. Norges Bank and Kredittilsynet are in principle in favour of greater acceptance of the use of risk mitigation techniques in the capital adequacy context. We consider it important to create incentives in the form of capital relief for the use of such systems and techniques.

The overall objective must be to ensure that the transfer of risk is real and irrevocable when such methods are employed. One cardinal issue is how the rules are to be designed in order best to take these techniques into account upon calculating the capital requirement and to achieve a harmonised implementation in order to secure a level playing field.

General principles
The Basel Committee proposes that general principles shall be applied which may be used across the various techniques and instruments within the categories collateral, on-balance sheet netting, guarantees and credit derivatives. Norges Bank and Kredittilsynet recognise the ability of general rules to cover a wide range of hedging instruments and techniques and their robustness to new methods. At the same time such an approach would mean that instruments with similar risk reducing effects would be dealt with in a consistent manner. Norges Bank and Kredittilsynet would nevertheless point out that the proposal will cause considerably more work in the form of interpretation of the regulatory framework, both as far as the institutions are concerned, and the supervisory authorities. Moreover, a more complex body of rules will also necessitate increasing the complexity and scope of administration and oversight of compliance. Norges Bank and Kredittilsynet want to stress that the continued efforts relating to these issues should endeavour to find ways of simplifying matters.

Operational requirements
Norges Bank and Kredittilsynet support the Committee's evaluations regarding legal aspects and requirements as to risk management. The complexity of the risk mitigation techniques is generally of a nature that makes it necessary to have sufficient focus on the management and control of operational risks occurring when such techniques are employed. Of core importance here will be risks associated with legal matters and documentation.

3.4 Asset Securitisation
Securitisation entails a re-distribution of risk from financial institutions to investors who must be expected to be capable of evaluating the risk and therefore demand to be compensated accordingly. This may also be used as a tool in managing risk since it is possible to sell unwanted assets or assets that are overrepresented in the portfolio. In the same manner, an institution may acquire assets that are underrepresented in the portfolio, thus achieving a lessening of the risk through wider diversification. When loans are being removed from the balance sheets of financial institutions, it is possible to handle the same volume of credit with a smaller amount of equity capital without adversely affecting the stability of the system. To achieve these effects, however, a number of prerequisites will have to be met.

In the context of capital adequacy securitisation transactions ought to be dealt with from various points of view. On the one hand banks are involved in the process in that they sell loans to a Special Purpose Vehicle (SPV) and/or in that they act as managers, provide credit support or liquidity support to the SPV. It is moreover a question how the claims should be risk weighted after having been securitised.

Neutrality
There is reason to assume that the capital adequacy regulatory framework has motivated a large number of the securitisation transactions until now. Banks' desire to reduce the capital requirement has in many instances been the main objective. Nevertheless it ought to be an objective that the regulatory framework regarding capital adequacy should have a neutral effect where such transactions are concerned.

Clean Break
The new Basel Capital Accord defines clear terms and conditions for ensuring a *"clean break"* between the portfolio sold and the lender bank. This is a precondition if the bank no longer is to be required to calculate a capital requirement for the sold portfolio. As the proposal has been presented it will be a contribution towards a harmonisation of the

regulatory framework for securitisation in the various countries, and Norges Bank and Kredittilsynet regard this as a positive aspect.

Reputational Risk and Cherry Picking
It may appear, however, that there are two sets of problems that have been inadequately resolved in the proposal. One concerns the handling of reputational risk to the originating bank. Even when all terms and conditions warranting a "true sale" have been met, it may still be conceivable that the bank will deem it expedient to provide some support to the SPV if it should turn out that there are major loan losses in the portfolio. The problem with this kind of risk is that it only becomes visible afterwards. It may nevertheless seem like the proposal might contribute in aggravating the consequences upon the originating bank of any such act.

In addition there is the problem relating to cherry-picking. When the originating bank transfers the best loans to a SPV, the claims on the SPV will obtain a high rating. At the same time the average quality of the portfolio remaining with the bank will be lowered. Especially in the case where the seller bank calculates its capital adequacy requirement according to the standardised approach, this will not necessarily have any effect on the capital ratio.

Risk weighting of securitised claims
The proposal from the Basel Committee has been drafted so that the risk weightings of securitised claims are lower than if the bank carries a direct claim in its balance sheet. The proposal may perhaps be justified by the fact that the loan portfolios underlying the securitised claims are more widely composed and for that reason entail less risk. At the same time, a lower risk weighting of securitised claims will represent a further incentive to offloading from the balance sheet of the bank. Norges Bank and Kredittilsynet regard it as unfortunate that the capital adequacy regulatory framework should provide such an incentive.

3.5 Operational risk
The New Basel Capital Accord proposes a separate capital requirement to cover the operational risk of banks. Three alternative methods of varying degrees of sophistication are set out in the proposal; "The Basic Indicator Approach", "The Standardised Approach" and "The Internal Measurement Approach". The Committee's proposals for The Basic Indicator Approach and The Standardised Approach provide a simple approach to the quantification of operational risk. Norges Bank and Kredittilsynet would nevertheless suggest that this is an acceptable approach since the institutions' own systems as of today are probably not sufficiently well developed for calculating the capital requirement. We are, moreover, of the view that the proposal may be expected to draw attention to these risks and to provide incentives for better control and management. In time, more advanced institutions may be capable of developing systems that will meet the requirements in "The Internal Measurement Approach".

Although the capital requirement for operational risk is anchored in the first pillar, we hold it to be important that sufficient attention is given to these risks when individual capital requirements are set within the second pillar. The manner in which the two most simple proposals have been designed, highlighting internal control etc. which might reduce operational risk, will have no direct effect in the form of a reduced capital requirement under the first pillar. Consequently, the supervisory authorities ought to have the opportunity to adjust the capital requirement relating to operational risk following closer supervisory evaluation. An individual capital requirement that is lower for institutions where efforts to

reduce the operational risk have been implemented will provide additional incentives for institutions to reduce such risks.

FNH and Sparebankeforeningen also consider that the current proposal for operational risk fails to provide sufficient incentives for banks to allocate resources to internal controls. Both organisations are of the view that the requirement is more appropriately placed under the second pillar where a more thorough and overall review is made of the relationship between financial strength and risk.

4. THE SECOND PILLAR - SUPERVISORY REVIEW PROCESS

The purpose of the second pillar is to review the capital situation of banks and their strategy for capitalisation as well as to ensure that the size of the total capital is consistent with the risk profile of the bank. The supervisory authorities shall be assured of a legal basis for determining individual capital requirements in cases where they consider that a bank is insufficiently capitalised. The reason for individual minimum requirements is that the risk profiles of banks are dissimilar, and that the general minimum requirements fail to take account of that dissimilarity.

Norges Bank and Kredittilsynet are basically in favour of the principles set out in the second pillar. The proposal may contribute to greater solvency in the banking industry by means of a more efficient supervision of banks at the same time as the banks are given an incentive to develop and improve their risk management systems. Since banks to a greater extent will use their own risk assessments, it is reasonable that the supervisory authorities conduct a more active follow up and evaluation of the risk profiles of banks as well as their risk management and internal control systems, and that, based on an overall assessment, they have the opportunity to impose a higher minimum capital requirement.

Resources needed and the scope of the second pillar

The New Capital Accord will mean that the overall system for capital adequacy will become substantially more complicated for banks as well as for the supervisory authorities. Where the latter are concerned, there will thus be a need for both an upgrading of competence and an increase of the resources available for handling a system that is considerably more comprehensive and complicated.

The New Basel Capital Accord, and in particular Pillar 2, contains strong elements of risk based supervision, and this would warrant that supervisory resources should be channelled to those institutions which represent the greatest risk to the financial system and/or where the system risk is the greatest. Norges Bank and Kredittilsynet therefore deem that it would be natural for the second pillar to be principally directed towards that type of institutions. In our view, institutions that represent a lesser degree of risk to the financial system could mainly be monitored by means of off-site supervision. The problem concerning the scope of the second pillar is in our view of particular relevance in connection with principle 3, which relates to the determination of individual capital requirements.

Changes in the supervisory methodology

Norges Bank and Kredittilsynet would point to the fact that Pillar 2 entails a material change in the methods of supervision. The proposal will mean that the supervisory authorities will be given a more active role in evaluating and approving the risk management systems of banks, the assessment of overall risk and the level of the capital adequacy as well as the power of

supervisory intervention. It is nevertheless a cardinal fact that it is the management and owners of the bank who are responsible for proper risk management and for taking appropriate action if and when problems arise.

The need for harmonised supervisory practice
In the "Supporting document to the New Basel Capital Accord" relating to the second pillar, it follows that it is not the purpose to harmonise the supervisory process in member and non-member countries, as different legal regimes, powers and styles of supervision will persist. As viewed by The Basel Committee, it is intended that the second pillar will encourage consistency in supervisory approaches and that supervisors will share their experience in implementing and practising Pillar 2.

Sparebankforeningen deems that both the supervisory authorities and banks will find it to their advantage that relatively precise standards are issued for the implementation of the second pillar. The Association considers that, unless definite standards have been established, it will be difficult for the supervisory authorities to command the requisite authority among banks when banks are ordered to increase their capital adequacy.

Norges Bank and Kredittilsynet are of the opinion that the new pillar will increase and highlight the need for international supervisory practices which are harmonised to the greatest possible extent in order to ensure that competitive conditions for banks are as equal as possible across national borders. We would therefore welcome the Basel Committee to draw up further guidelines on implementation and practising of the second pillar. Norges Bank and Kredittilsynet would here refer to the work done under the auspices of Group de Contact of Banking Supervisors in the EEA-area on "supervisory convergence" and "high level principles on supervisory review".

Any guidelines on how to practise Pillar 2 should also contain further provisions regarding the determination of individual capital requirements. As far as the supervisory authorities are concerned, it may be difficult to determine how risk profiles or shortcomings in the risk management procedures may result in an explicitly higher capital requirement. Any shortcomings in the risk management procedures will require a qualitative assessment that cannot be directly translated into a quantitative charge. At the same time persuasive arguments will be required of the supervisory authorities if a capital charge higher than the minimum is to be imposed on banks operating well-founded, complex risk management systems.

Interest rate risk in the banking book
The Basel Committee cites that there is considerable heterogeneity between internationally active banks with regard to the "nature of underlying risk" and the processes for managing and monitoring such risk. Against this background the Committee considers that interest rate risk in the banking book should be dealt with in Pillar 2. The Basel Committee nevertheless mentions that an explicit minimum requirement may be relevant provided that the banks are sufficiently homogenous.

Norges Bank and Kredittilsynet would refer to the fact that interest rate risk in the banking book can for certain institutions represent a considerable risk. For competitive reasons it is therefore essential to ensure consistent treatment of such risk among the supervisory authorities in various countries. In our view, therefore, the main rule ought to be that interest rate risk in the banking book should be dealt with under the first pillar, and that only in

exceptional cases should it be dealt with in the second pillar. An explicit capital requirement will also reduce the possibilities for arbitrage between the banking book and the trading book.

FNH and Sparebankforeningen also take the view that this risk should have been included in the first pillar and cite amongst others that well tried methods exist for the calculation of interest rate risk.

5. THE THIRD PILLAR – MARKET DISCIPLINE

Norges Bank and Kredittilsynet consider that the third pillar ("market discipline") is important to ensure both greater transparency and harmonisation of standards for external reporting. This may in turn be important for enabling market disciplining mechanisms to function. This is also founded on a reasonable trade-off, since banks to a greater extent will be using their own assessments of risk and capital adequacy, it is reasonable that this should be balanced by stricter requirements for transparency and the disclosure of information.

Degree of disclosure

The third pillar imposes very extensive disclosure requirements that are to be published as part of the financial reporting by the institution (annual accounts). IASC has prepared standards for supplementary disclosures that must be assumed to coincide in many respects with the Basel proposal. In the view of Kredittilsynet and Norges Bank, a co-ordination of the IASC and the Basel proposal on the subject of supplementary discloures would be desirable.

The Basel proposal furthermore distinguishes between requirements and recommendations. Norges Bank and Kredittilsynet are of the opinion that it is unfortunate to regulate by means of recommendations since the legal standing of any such provisions will be be uncertain. In Norway corresponding recommended requirements were previously included in the regulations concerning annual accounts. That provision has now been amended to be an order because of the uncertain situation to which it gave rise to.

Sparebankforeningen deems it important that the information requirements and recommendations should not be so comprehensive that they may lack focus. One possible solution to this problem may be, according to the Association, that a set of requirements to be prepared for all banks, while those banks that use IRB will be subject to additional disclosure requirements.

Disclosure of individually determined capital requirements

The second pillar enables the authorities to impose on an institution a capital requirement above the minimum requirement. It is a cardinal issue whether the institution should disclose this through the third pillar or whether such information should not be made available to the markets. One objection to making individually determined capital requirements public may be that institutions with a low capital requirement might want to make that information public in order to gain a competitive advantage.

Norges Bank and Kredittilsynet will, however, refer to the fact that the institutions' capital ratio in general is information available for the public (e.g. through reports and accounts). If details of individually determined capital requirements are not to be published, it might imply that these these institutions - in publishing seemingly higher capital ratios - will give the impression of being more financially sound compared with institutions not subject to such higher capital requirement. In our view this may undermine the main objective of market discipline, as the disciplinary functions of the market will be distorted by misleading

information about capital ratios. We would, consequently, support a requirement for institutions to make public through Pillar 3 whether they have been subjected to a higher capital requirement by the supervisory authorities. Therefore, we will support a requirement that institutions via Pillar 3 have to disclose their capital requirements regularly. This will also be relevant for the stock exchange and securities markets.

Particular circumstances might imply that the timing of the disclosure is in itself of great significance, something which the supervisory authorities in certain cases will have to emphasise in their assessments.

6. CONSEQUENCES FOR THE CAPITAL ADEQUACY RATIO IN NORWEGIAN BANKS

In co-operation with Sparebankforeningen and FNH, Norges Bank and Kredittilsynet have carried out a study of 12 selected commercial banks and savings banks relating to the impact of the Basel Committee's proposal on the capital ratios. A more detailed presentation of these calculations is given in appendix 3 to this consultation statement. The calculations are limited to the Standardised Approach for calculating the capital requirement for credit risk and to the Basic Indicator Approach for calculating the capital requirement for operational risk. There is some uncertainty attached to the figures, and the figures for the various banks are not directly comparable, as some of the banks have taken group figures as their basis for the calculations, while other banks have used figures from the parent bank.

The main conclusion is that the capital requirement for operational risk will have the greatest implications for the banks' capital adequacy. The calculations show a weakening in the tier 1 capital ratio (in total) of the selected banks of around 1 to 2 percentage points with the "Basic Indicator Approach". In these figures no account has been taken of Credit Risk Mitigation (CRM) in the standardised approach.

The proposal from The Basel Committee affects the risk-weighted exposures. The level of total capital will not be changed as a result of the proposal.

The impact study is based on data as of 31 December 2000.

Credit risk

All the banks will be subject to a stricter capital requirement as a result of the standardised approach. When the 12 banks are viewed together there is a reduction in the tier 1 capital ratio from 7.8 per cent under the current regulatory framework to 7.6 per cent under alternative 1 for risk weighting of non-central government public sector entities (PSEs) and banks. The capital ratio is similarly reduced from 11.1 per cent to 10.8 per cent. Under alternative 2 there is a reduction of the tier 1 capital ratio and the capital ratio to 7.3 per cent and 10.5 per cent, respectively. The difference in the tier 1 capital ratio and the capital ratio between alternative 1 and alternative 2 reflects the fact that only very few of the PSEs and the banks are rated. These figures do not take CRM into consideration. Most of the banks reported that the extent of such techniques is limited at present, and that it has been difficult to provide data for calculating the effect on the capital requirement.

The following tabulation shows how the various parts of the Basel Committee's proposal is going to affect the total risk-weighted exposures in the three largest banks; Den norske Bank, Christiania Bank and Gjensidige NOR Sparebank (a savings bank):

Table. The effect on risk-weighted exposures by type of claim and sector for DnB, CBK and Gjensidige NOR Sparebank. NOK Million.

Claim	Sector	Current risk weighted exposures	Change in risk weighted exposures alt. 1	Change in risk weighted exposures alt. 2
Assets	Sovereigns	0	0	0
	PSEs	2.160	0	3.170
	Institutions[1]	16.130	1.500	13.460
	Corporates	290.460	830	830
	Others	148.380	0	0
Business commitments	Sovereigns	0	0	0
	PSEs	40	520	700
	Institutions[1]	260	340	1.230
	Corporates	27.420	8,200	8.200
	Others	130	40	40
OTC-derivatives	Sovereigns	0	2	2
	PSEs	350	0	510
	Institutions[1]	8.700	0	3.610
	Corporates	3.350	3,120	3.120
	Others	30	10	10
Other off-balance sheet items	Sovereigns	0	8	8
	PSEs	300	2	580
	Institutions[1]	1.810	30	1.480
	Corporates	44.190	-430	-430
	Others	140	0	0

The figures are a combination of group figures and parent bank figures. In addition, for one of the banks the figures only represent a fraction of the risk-weighted exposures. Although the figures are not directly comparable, the tabulation nevertheless provides a certain indication of the changes in risk-weighted exposures.

It will be seen from the tabulation that the exposures where the counterpart is an institution[1] or a PSE provide the largest changes in the risk-weighted exposures of NOK 16.5 billion under the alternative 2. The other types of claim shows corresponding changes under the alternative 2.

With regard to changes that are not associated with alternative 1 and alternative 2 for risk weighting of PSEs and banks, risk-weighted exposures will increase as a result of the introduction of capital requirements for business commitments with an original maturity up to one year. The removal of the 50 per cent ceiling on counterparty risks weightings of OTC derivatives also contributes significantly. The effect on risk-weighted exposures of these proposals for business commitments and OTC-derivatives represents around NOK 9 billion and NOK 3.1 billion, respectively.

[1] Institutions include credit institutions, investment firms and insurance companies. Claims on insurance companies are in Norway under the current regulation subject to a 20 per cent risk weight.

Operational risk
According to the proposal from the Basel Committee the capital requirement for operational risk should constitute around 20 per cent of the current capital requirement. Based on this it is possible to calculate the value of alpha in the Basic Indicator Approach and the values of beta in the Standardised Approach.

Basic Indicator Approach
The capital requirement under the Basic Indicator Approach is defined as gross income (as defined in the proposal from the Basel Committee) multiplied by alpha. Given that the capital requirement is to constitute 20 per cent of the current capital requirement, the Basel Committee has given a preliminary estimate of the alpha of 30 per cent. Based on the data collected from the Norwegian Banks the alpha looks in average to be somewhat over 30 per cent. The estimated alpha values vary from 19 to 50 per cent. Since the selection of banks is limited and that there is uncertainty attached to the figures, the estimates should be interpreted with every caution.

The capital requirement for operational risk will come in addition to the capital requirements for credit risk and market risk. If the basis to be taken is an alpha of 30 per cent, as the Basel Committee implies, there is a reduction in the tier 1 capital adequacy for the 12 banks together, from 7.8 per cent under the current regulatory framework, to 6.5 per cent. The capital ratio for the same banks is reduced from 11.1 per cent under the current regulation, to 9.3 per cent. The calculations assume alternative 1 for risk weighting of PSEs and banks.

The Standardised Approach
The Standardised Approach has seven "business lines", each with a belonging beta factor. The beta factor may be calibrated according to the assumptions given in annex 3 of "Operational Risk – Supporting Document to the New Basel Capital Accord", at page 21.

Several of the banks have not reported data under the Standardised Approach. At the same time none of the remaining banks reported data for all of the seven "business lines". It is therefore difficult to obtain a reliable estimate of the beta factors, and the figures have not been stated here. Even though the figures are uncertain and show considerable variation within each "business line", the estimates appear to be in line with preliminary studies from Basel. It will be necessary to have a larger number of banks in order to be able to provide a more exact estimate of the beta factors. The small number of banks means that including or excluding one single bank could result in substantial changes in the estimated beta values. In view of this, no calculations have been made of how the Standardised Approach might affect the capital ratio.

Conclusion
This impact study shows that the capital requirement for operational risk contributes to a significant increase in the aggregate (credit risk, market risk and operational risk) capital requirement for the participating banks. Norges Bank and Kredittilsynet are of the opinion that this should be taken into consideration in the further calibration of the capital requirement.

The Quantitative Impact Study
Three Norwegian banks also participate in "The Quantitative Impact Study" under the auspices of The Basel Committee. These results will be forwarded to the Committee by the end of June 2001.

THE NEW BASEL CAPITAL ACCORD – CONSEQUENCES FOR THE CAPITAL ADEQUACY RATIO IN NORWEGIAN BANKS.

Introduction

In co-operation with Sparebankforeningen and FNH, Norges Bank and Kredittilsynet have carried out a study of 12 selected commercial banks and savings banks relating to the impact of the Basel Committee's proposal on the capital ratios. The calculations are limited to the Standardised Approach for calculating the capital requirement for credit risk and to the Basic Indicator Approach for calculating the capital requirement for operational risk. There is some uncertainty attached to the figures, and the figures for the various banks are not directly comparable, as some of the banks have taken group figures as their basis for the calculations, while other banks have used figures from the parent bank.

Most banks have encountered problems in carrying out the calculations. The reason was in part that data for the study are found across the computer systems of the banks and that several of the banks perceived the proposal from the Basle Committee as complicated.

The main conclusion is that the capital requirements for operational risk will have the greatest implications for the banks' capital adequacy. The calculations show a weakening in the tier 1 capital adequacy (in total) of the selected banks of around 1 to 2 percentage points with the "Basic Indicator Approach". In these figures no account has been taken of Credit Risk Mitigation (CRM) in the standard method.

The proposal from the Basle Committee affects the basis for the calculation. The level of total capital will not be changed as a result of the proposal.

The mapping is based on data available as of 31 December 2000.

Credit risk

All the banks will be subject to a stricter capital requirement as a result of the standardised approach. When the 12 banks are viewed together there is a reduction in the tier 1 capital ratio from 7.80 per cent under the current regulatory framework to 7.61 per cent under the alternative 1 for risk weighting of non-central government public sector entities (PSEs) and banks. The capital ratio is similarly reduced from 11.12 per cent to 10.84 per cent. Under alternative 2 there is a reduction of the tier 1 capital ratio and the capital ratio to 7.33 per cent and 10.45 per cent, respectively. The difference in the tier 1 capital ratio and the capital ratio between the alternative 1 and alternative 2 reflects the fact that only very few of the PSEs and the banks are rated. These figures do not take CRM into consideration. Most of the banks reported back that the extent of such techniques is limited at present and that it has been difficult to provide data for calculating the effect on the capital requirement.

The effect on the tier 1 capital ratio and the capital adequacy ratio for the individual commercial banks will be seen from table 1 and table 2, respectively.

Table 1. Tier 1 capital ratio for commercial banks. Per cent

	Tier 1 capital ratio - current regulation	Tier 1 capital ratio - alternative 1 without CRM	Tier 1 capital ratio – alternative 2 without CRM
Bank 1	7.65	7.39	7.19
Bank 2	7.47	7.43	7.23
Bank 3	7.12	7.04	6.95
Bank 4	6.20	6.00	5.72
Bank 5	7.57	7.32	7.18
Sum	7.46	7.28	7.08

Table 2. Capital adequacy for commercial banks. Per cent

	Capital ratio – current regulation	Capital ratio - alternative 1 without CRM	Capital ratio – alternative 2 without CRM
Bank 1	10.76	10.38	10.11
Bank 2	10.35	10.29	10.02
Bank 3	8.42	8.32	8.21
Bank 4	10.31	9.98	9.51
Bank 5	10.50	10.15	9.95
Sum	10.47	10.22	9.95

The figures for the individual commercial banks are not directly comparable. Bank 1, Bank 3 and Bank 4 have based the calculations on group figures, while Bank 2 and Bank 5 have taken as their basis the parent bank figures. The tier 1 capital ratio and the capital ratio for Bank 1 under the current regulatory framework are somewhat below the figures reported due to some adjustments in the basic data. Moreover Bank 2 has limited its calculations to 82 per cent of current risk weighted exposures because of a lack of available data. The figures for Bank 2 is scaled up to 100 per cent assuming that this proportion gives a representative composition of risk weighted exposures.

The effect on the tier 1 capital ratio and the capital ratio for the individual savings banks will be seen from table 3 and table 4, respectively. Bank 8 and Bank 12 show group figures. The other savings banks have based their calculations on parent bank figures.

Table 3. Tier 1 capital ratio for savings banks. Per cent

	Tier 1 capital ratio - current regulation	Tier 1 capital ratio - alternative 1 without CRM	Tier 1 capital ratio – alternative 2 without CRM
Bank 6	8.67	8.45	7.79
Bank 7	7.93	7.75	7.59
Bank 8	8.29	8.14	7.86
Bank 9	9.62	9.05	8.78
Bank 10	9.34	8.75	8.67
Bank 11	9.79	9.56	9.49
Bank 12	8.66	8.64	8.49
Sum	8.65	8.40	7.92

Table 4. Capital ratio for savings banks. Per cent

	Capital ratio – current regulation	Capital ratio - alternative 1 without CRM	Capital ratio – alternative 2 without CRM
Bank 6	13.26	12.91	11.90
Bank 7	12.59	12.31	12.06
Bank 8	10.37	10.18	9.83
Bank 9	13.07	12.30	11.93
Bank 10	10.84	10.15	10.06
Bank 11	12.03	11.75	11.66
Bank 12	11.61	11.59	11.39
Sum	12.71	12.34	11.63

For the purpose of studying how the various parts of the Basle Committee's proposal affects the banks' capital adequacy, a more detailed presentation is given in table 5. Table 5 shows risk weighted exposures for the three largest Norwegian banks (Den norske Bank, Christiania Bank and Gjensidige NOR Sparebank) (a savings bank) according to the type of claim and sector. These figures are also a mixture of group figures and parent bank figures. In addition, the figures represent for one of the banks only a selection of total risk weighted exposures. Although here, too, the figures are not immediately comparable, the table nevertheless provides an indication of the changes in risk weighted exposures.

Table 5. The effect on risk-weighted exposures by type of claim and sector for DnB, CBK and Gjensidige NOR Sparebank. NOK million.

Claim	Sector	Current risk weighted exposures	Change in risk weighted exposures alt. 1	Change in risk weighted exposures alt. 2
	Sovereigns	0	0	0
	PSEs	2,160	0	3,170
Assets	Institutions[1]	16,130	1,500	13,460
	Corporates	290,460	830	830
	Others	148,380	0	0
	Sovereigns	0	0	0
Business	PSEs	40	520	700
commitments	Institutions[1]	260	340	1,230
	Corporates	27,420	8,200	8,200
	Others	130	40	40
	Sovereigns	0	2	2
OTC-	PSEs	350	0	510
derivatives	Institutions[1]	8,700	0	3,610
	Corporates	3,350	3,120	3,120
	Others	30	10	10
	Sovereigns	0	8	8
Other off-	PSEs	300	2	580
balance sheet	Institutions[1]	1,810	30	1,480
items	Corporates	44,190	-430	-430
	Others	140	0	0

Table 5 shows, as do tables 1-4, that the alternatives for risk weighting of banks and PSEs is of greatest significance for risk weighted exposures. These changes in risk weighted exposures can be explained by the fact that only a few of those counterparts are rated. The table shows that assets where the counterpart is an institution[1] or a PSE provide the largest changes in the risk-weighted exposures of NOK 16.5 billion under the alternative 2. The other types of claim shows corresponding changes under the alternative 2.

Under alternative 2 a preferential risk weigh is given to claims with a maturity of less than 3 months. The effect of this proposal has not been quantifiable because the banks have not been able to divide such claims according to maturity.

With regard to changes that are not associated with alternative 1 and alternative 2 for risk weighting of PSEs and banks, risk-weighted exposures will increase as a result of the introduction of capital requirements for business commitments with an original maturity up to one year. The removal of the 50 per cent ceiling on counterparty risks weightings of OTC derivatives also contributes significantly. The effect on risk-weighted exposures of these

[1] Institutions include credit institutions, investment firms and insurance companies. Claims on insurance companies are in Norway under the current regulation subject to a 20 per cent risk weight.

proposals for business commitments and OTC-derivatives represents around NOK 9 billion and NOK 3,1 billion, respectively.

Operational risk

According to the proposal from the Basel Committee the capital requirement for operational risk should constitute around 20 per cent of the current capital requirement. Based on this it is possible to calculate the value of alpha in the Basic Indicator Approach and the values of beta in the Standardised Approach.

The Basic Indicator Approach

The capital requirement under the Basic Indicator Approach is defined as gross income (as defined in the proposal from the Basel Committee) multiplied by alpha. Given that the capital requirement is to constitute 20 per cent of the current capital requirement, the Basel Committee has given a preliminary estimate of the alpha of 30 per cent. Based on the data reported from the banks, alpha[2] for commercial banks and savings banks has been estimated in table 6 and table 7, respectively

Table 6. Estimated alpha – commercial banks

	Alpha
Bank 1	34 %
Bank 2	42%
Bank 3	19%
Bank 4	38%
Bank 5	48%
Sum	36%

Table 7. Estimated alpha – savings banks

	Alpha
Bank 6	34 %
Bank 7	32%
Bank 8	37%
Bank 9	50%
Bank 10	28%
Bank 11	35%
Bank 12	34%
Sum	34%

The estimated alphas vary among the banks, but appear on average to be somewhat above 30 per cent. Since the selection of banks is limited and that there is uncertainty attached to the figures, the estimates should be interpreted with every caution.

The capital requirement for operational risk is additional to the capital requirements for credit risk and market risk. Tier 1 capital ratio and capital ratio for commercial banks and savings banks including the capital requirement for operational risk will be seen from tables 8 to 11. These calculations assume an alpha of 30 per cent as indicated by the Basle Committee. It is further assumed alternative 1 for risk weighting of PSEs and banks (capital requirement for credit risk).

[2] Alpha=20 per cent of current capital requirement/Gross inncome.

Table 8. Tier 1 capital ratio for commercial banks – including operational risk. Per cent

	Tier 1 capital ratio – current regulation	**Tier 1 capital ratio – alternative 1 without CRM**
Bank 1	7.65	6.31
Bank 2	7.47	6.50
Bank 3	7.12	5.34
Bank 4	6.20	5.20
Bank 5	7.57	6.54
Sum	7.46	6.25

Table 9. Capital ratio for commercial banks – including operational risk. Per cent

	Capital ratio – current regulation	**Capital ratio – alternative 1 without CRM**
Bank 1	10.76	8.87
Bank 2	10.35	9.00
Bank 3	8.42	6.31
Bank 4	10.31	8.65
Bank 5	10.50	9.06
Sum	10.47	8.78

Table 10. Tier 1 capital ratio for savings banks – including operational risk. Per cent

	Tier 1 capital ratio – current regulation	**Tier 1 capital ratio – alternative 1 without CRM**
Bank 6	8.67	7.21
Bank 7	7.93	6.70
Bank 8	8.29	6.92
Bank 9	9.62	7.21
Bank 10	9.34	7.86
Bank 11	9.79	7.93
Bank 12	8.66	7.38
Sum	8.65	7.19

Table 11. Capital ratio for savings banks – including operational risk. Per cent

	Capital ratio – current regulation	**Capital ratio – alternative 1 without CRM**
Bank 6	13.26	11.02
Bank 7	12.59	10.64
Bank 8	10.37	8.66
Bank 9	13.07	10.48
Bank 10	10.84	9.12
Bank 11	12.03	9.74
Bank 12	11.61	9.90
Sum	12.71	10.56

As is evident from table 8, the capital requirement for operational risk entails that all commercial banks in the selection fall below a tier 1 capital ratio of 7 per cent. Correspondingly, table 10 shows that two of the seven savings banks fall below a tier 1 capital ratio of 7 per cent.

The Standardised approach

The Standardised Approach has seven "business lines", each with a belonging beta factor. The beta factor may be calibrated according to the assumptions given in annex 3 of "Operational Risk – Supporting Document to the New Basel Capital Accord", at page 21[3].

Several of the banks have not reported data under the Standardised Approach. At the same time none of the remaining banks reported data for all of the seven "business lines". It is

[3] Mean values have been assumed for weighting of "Business lines".

therefore difficult to obtain a reliable estimate of the beta factors, The estimated beta factors have, nevertheless, been set out in table 12.

Table 12. Estimated beta factors - commercial and savings banks

	Beta	**No. of banks**
Corporate finance	172 %-263%	2
Trading and sales	62%-204%	7
Retail Banking	0.3%-1.4%	9
Commercial Banking	0.3%-1.9%	9
Payment and Settlement	0.02%-7.3%	5
Retail Brokerage	211%	1
Asset Management	0.4-5.0%	4

Even though the figures are uncertain and show considerable variation within each "business line", the estimates appear to be in line with preliminary studies from Basel. It will be necessary to have a larger number of banks in order to be able to provide a more exact estimate of the beta factors. The small number of banks means that including or excluding one single bank could result in substantial changes in the estimated beta values. In view of this, no calculations have been made of how the Standardised Approach might affect the capital ratio.

FNH Norwegian Financial Services Association

Norwegian Financial Services Bureau

The Basle Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Date: 03.05.2001
Our ref.: 2001/000090
FJA/TH
Your ref.:

COMMENTS ON THE CONSULTATIVE DOCUMENT ON THE NEW BASEL CAPITAL ACCORD

The Financial Services Association of Norway (FNH), which represents the interests of commercial banks and insurance companies operating in Norway, welcomes the opportunity to comment on the work of the Basle Committee on Banking Supervision (the Committee). Our comments are submitted to Kredittilsynet (the Banking, Insurance and Securities Commission of Norway) and Norges Bank (the Central Bank of Norway) for forwarding to the Committee.

FNH is member of the European Banking Federation and of the European Mortgage Federation. We support the work carried out by these two organisations on behalf of the European banking industry in respect to the proposed New Capital Accord.

The Basle Capital Accord is a centrepiece of the banking regulation worldwide. Taking into consideration the importance of the Accord for prudential regulation and the degree to which the current Accord is proposed changed, FNH finds the time the Committee has allowed for consultation with the industry to be too short. Norwegian banks are at the time these comments are requested by the national supervisors still in a process of studying in detail how the proposed New Accord will affect their operations. The two largest commercial banks and the largest savings bank have been asked to answer the Quantitative Impact Study of the Committee, including the part on the internal ratings based approach. The results of these studies will be communicated to the Committee by Kredittilsynet and Norges Bank in due time. Our comments in this letter are thus of a more general and principal nature. They will only address issues related to the first pillar – minimum capital requirements.

In our comments references are made to paragraphs in the consultative document on the New Basel Accord if not otherwise stated.

Postal address:
P.O. Box 2473 Solli
N-0202 Oslo

Address:
Hansteensgt. 2, Oslo
E-mail: fnh@fnh.no
Internet: www.fnh.no

Telephone:
+47 23 28 42 00
Fax:
+47 23 28 42 01

Organization number
Finansnæringens Hovedorganisasjon
NO 981 423 682
Finansnæringens Servicekontor
NO 969 000 938

1. CREDIT RISK – THE STANDARDISED APPROACH

1.1 General rules

Claims on banks, *cf. paragraphs 29-33 and paragraphs 24-30 in the supporting document on the standardised approach*
FNH supports the use of the first option for claims on banks, i.e. the option under which all banks incorporated in a given country will be assigned a risk weight one category less favourable than that assigned to claims on the sovereign of incorporation, capped at 100%. It will allow all Norwegian credit institutions to keep the 20% risk weight, which is important for funding purposes. Under the second option only two specialised Norwegian credit institutions with a limited market share in the domestic market will keep the 20% risk weight, while the rest of the banking sector will be assigned a higher risk weight – 50%. Thus, in a Norwegian perspective the second option is hardly more risk sensitive than the first alternative, as nearly the whole banking sector will receive the same risk weight. The more than doubling of the current risk weight for Norwegian banks under option two is not warranted from a risk perspective, therefore we have a clear preference for the first option.

In the second option for claims on banks maturity is taken into consideration. The Committee proposes a preferential risk weight one category more favourable than otherwise to claims with an original maturity of 3 months or less. FNH is aware that the Committee has carried out an analysis in respect of inter-bank lending which showed that the upper bound of such lending in the markets surveyed generally were 3 months. Despite such finding in the most significant markets we would strongly advise that the Committee allow for the use of such a preferential risk weight for somewhat longer short-term maturities. Norwegian banks make use of inter-bank lending up to 6 months. Differences in the risk weight between long-term and short-term claims will give banks strong incentives to make use of short term funding, as it will be defined in the New Accord. If the limit for short-term lending (funding of other banks) is drawn at 3 months, rather than at 6 months as indicated in the first consultative paper, the New Accord will in a paradoxical way contribute to an increased liquidity risk in the banking system in countries where inter-bank funding up to 6 months is common and where the second option is applied.

Claims secured on real estate, *cf. paragraphs 37 and 38*
We would like to state that we in principle welcome that the Committee has proposed explicit criteria in the New Accord for defining exceptional treatment of commercial real estate lending. Provided that the European Union and the Basle-Committee can agree on a common standard, this will help to promote a level playing field for such lending in Europe in general. FNH refers otherwise to the work that is being carried out by the European Mortgage Federation with respect to the treatment of mortgage lending.

Risk weights of retail assets, *cf. paragraph 40 in the supporting document on the standardised approach*
The Committee state in the supporting document on the standardised approach that it, depending on the work on the internal ratings based approach, will review the appropriate treatment for retail portfolios in the standardised approach. We welcome this statement by the Committee. We would like to se a risk weight for well diversified retail portfolios in the standardised approach - i.e. portfolios other than mortgage loans - below 100%.

Off-balance sheet items, *cf. paragraph 42*
If the 50% ceiling on counterparty risk weightings of OTC derivative transactions will no longer apply, it is important that the higher add on percentages for the potential future exposure of transactions with a maturity greater than 1 year are decreased in line with comments provided by International Swaps and Derivatives Association (ISDA) to the Basle Committee. ISDA shows that a consistent treatment of credit risk on- and off-balance sheet would imply the use of a 1 year time horizon for the potential future exposure over the remaining life of the contract. This is due to the fact that the IRB approaches are based on 1 year estimation of PDs for exposures.

1.2 Credit risk mitigation in the standardised approach

FNH is in general disappointed that no recognition is made of the double default effect of taking collateral or using guarantees in the standardised approach or in the Internal Ratings Based (IRB) approaches. We are also surprised about the very stringent conditions under which credit risk mitigation (CRM) techniques are recognised, taking into consideration the importance such techniques have in reducing the risk of individual banks and of the banking system at large.

- **Collateral**

Eligible collateral, *cf. paragraphs 76-79*
The collateral instruments eligible for recognition in the simple approach and in the comprehensive approach should be the same. Equities not included in a main index but traded on a recognised exchange should thus be recognised as a collateral instrument under both approaches, i.e. not only under the comprehensive approach. The use of the expression "main index" may create an arbitrary distinction between equities recognised and equities not recognised as eligible collateral in the simple approach. There is no uniform definition of a "main index", nor are there uniform criteria for which companies can be included in such an index.

'W-factor', *cf. paragraph 117 in the supporting document on the standardised approach*
The supporting document on the standardised approach explains the reasoning behind the use of the *w-factor for collateral in the c*omprehensive approach. It is argued that a bank which relies on collateral face a risk of being unable to establish title to the collateral in order to sell it, or the collateral may otherwise turn out to be effectively worthless. The

bank can therefore remain fully exposed to the underlying obligor. FNH recognises that a failure to establish title to posted collateral may occur for collateral banks have established under Norwegian jurisdiction, but only in rare and exceptional cases. Uncertainty regarding the definition of default has not proven to be a problem in the Norwegian market in the past. All securities issued by Norwegian issuers furthermore are registered securities, not bearer securities. Such securities are registered in a central securities registry, in which any specific legal claim on the securities or on the account in which the securities are registered are documented. Close out netting will provide banks with security in repo transactions. The main reason a bank may not be able to establish title to securities posted as collateral is if the bank makes an operational mistake when establishing the securities as collateral, or in the day-to-day operations of maintaining that collateral. Thus, such risk constitutes primarily an operational risk.

The risk of having the value of the collateral reduced is explicitly accounted for through the haircut applied to the value of the collateral. The risk that the remaining value of the collateral after taking into account the haircut may turn out to be effective worthless, is our view not relevant for financial collateral such as cash on deposit, debt securities or gold. This risk factor could, however, be more relevant for physical collateral recognised under the IRB approach. Based on the above FNH is of the opinion that the w-factor for collateral should be disapplied. It will otherwise create double counting of risk because the risk which it is aimed at covering, already is well accounted for in the proposed operational risk charge. If the Committee is concerned that some banks may be exposed to residual risk not accounted for in the first pillar, e.g. as a result of extensive use of lower-quality collateral, it should make this a specific issue for consideration under the second pillar.

Comprehensive approach - own estimates for haircuts, *cf. paragraph 92*
The Committee suggests to makes the use of own estimates for haircuts conditioned on banks' having received supervisory recognition for an internal market risk model under the 1996 Market Risk Amendment. FNH believes such a condition could be harmful, because it would too strictly limit banks ability to use own estimates. Banks that make use of eligible collateral may have a limited trading book, for which the burden of seeking supervisory recognition for an internal market risk model would not be justified. Such banks should, however, be allowed an opportunity to use their own estimates for haircuts, given supervisory approval. Such approval should be based on the need to regulate haircuts for collateral in a bank's banking book, not the need to regulate the trading book of institutions with a large trading book.

Capital-market driven transactions, *cf. paragraphs 65, 81 and 107*
FNH notes that the capital treatment of capital-market driven transactions in the form of repos/reverse repos, securities lending/borrowing and margin lending in the banking book will become much more severe in the New Accord as compared the current Accord. Under the comprehensive approach a haircut will in addition be applied to the market value of the collateral, and the w-factor will be applied to the collateralised portion of the exposure after adjusting for the haircut, unless the transaction comes under the special treatment for

government repo-style transactions. As stated above FNH is of the opinion that application of the w-factor to collateralised transactions creates a double counting of risk that would be inconsistent with the objectives of the new Capital Accord. Furthermore, we are of the opinion that even if the w-factor were disapplied for collateralised transactions under the standardised approach, the new treatment of capital-market driven transactions in the banking book would not be suitable for use in the trading book. It would provide incentives harmful for the efficient functioning and future development of these markets. The trading book treatment of these transactions should not be made more severe.

- **On-balance sheet netting**, *cf. paragraphs 112-116*

FNH commends the Committee for recognising the risk reducing effect of on-balance sheet netting agreements in the New Capital Accord in addition to the already existing rules on off-balance sheet netting in the current Accord. We support the treatment of on-balance sheet netting as a collateralised transaction without application of the w-factor.

The use of netting agreements both on-balance and off-balance, are important credit risk mitigation techniques. Norwegian banks are currently in the unfortunate situation, however, that the regulatory authorities have not been willing to create a legal basis for bilateral netting of off-balance sheet items other than currency and interest rate related contracts. Nor have they been willing to recognise for capital adequacy purposes off-balance sheet netting agreements based on a well-founded legal basis with counterparts in other jurisdictions covering contracts other than those recognised for netting between two Norwegian counterparts.

- **Guarantees and credit derivatives**

Credit derivatives
The current Norwegian capital adequacy regulation does not explicitly address the risk associated with credit derivatives. Banks may in principle, however, involve in such activities. The result being that there is uncertainty whether the credit risk protection bought, or eventual protection sold, should be taken into account in the calculation of a bank's capital adequacy ratio. On this background, FNH strongly supports the development of an international common standard for the treatment of credit derivatives.

In line with our thinking on collateral we are of the clear opinion that the w-factor also should be disapplied for credit derivatives, in order to avoid double counting of operational risk. It seems furthermore unjustified that a credit default swap issued by a bank should be treated differently from guarantees issued by the same bank. Supplementary requirements could be set under the second pillar for those institutions where supervisors are particularly concerned about residual risk. Given the fact that Norwegian banks have not engaged in credit derivatives to any significant degree so far, we do not have any other comments on the details of the Committee's proposal for credit derivatives. As mentioned previously, however, we support the work carried out by the European Banking Federation, which are

expected to comment more in detail on the treatment of credit derivatives in the Committee's proposal.

Risk weights for guarantees, *cf. paragraphs 130-145*
According to the consultation paper guarantees from sovereign, central banks and banks will be treated according to 'the pure substitution method', i.e. similar to the treatment in the current Accord. Exposures guaranteed by other eligible guarantors than those mentioned above will be assigned a risk weight that is a weighted average of the obligor's risk weight and the protection provider's risk weight. This treatment also applies to guarantees issued by highly rated insurance companies and corporates, for which the risk weight of direct claims can be the same as banks and sovereigns.

For a fully-protected exposure a w-factor of 15% is applied to the obligor's risk weight, while the residual – 85% – is applied to the protection provider's risk weight. As we understand the proposal the w-factor is included in order to take account of banks not being able to fully assess, monitor and manage the contingent credit risk towards a guarantor. We are, as already mentioned above, in principle opposed to the use of a w-factor, because it creates a double counting of risk. Risk related to a bank's use and handling of guarantees is an operational risk. For banks that make very extensive use of guarantees from eligible guarantors other than those first mentioned this operational risk could be addressed under the second pillar of the New Accord.

2. CREDIT RISK – THE INTERNAL RATINGS BASED APPROACH

FNH wishes to commend the Committee on the development of the IRB approaches. We support in general the proposed framework for the IRB approaches and the methodology developed. This support is conditioned, however, on the IRB approaches being constructed and calibrated in such a way that there in general will be incentives for Norwegian and other European banks to move from the standardised approach to the IRB foundation approach. Preliminary findings indicate that this will not be the case under the proposed calibration. A problem regarding the calibration of the current IRB proposals, especially the foundation approach for corporate exposures, is recognition of risk mitigating effects of financial collateral, physical collateral, and guarantees. FNH is of the opinion that, even if there has been progress, there is still not sufficient recognition of the economic value of risk mitigation techniques. The Basle Qualitative Impact Study will give the Basel Committee inputs on further calibrating the formula for derivation of risk weights. Three Norwegian banks have been asked by the national supervisor to take part in the study covering IRB calculations. At the time these comments are being submitted to the national supervisor no results from the study is available. FNH would, however, like to comment on some general and principal issues related to the IRB approaches.

Project finance, *cf. paragraph 157 and paragraphs 396 -420 in the supporting document on the IRB approach*
FNH welcomes the Committee's recognition in the supporting document paragraph 403 that the preliminary definition of project lending without amendment is likely to bee too broad, and that additional qualifications are required to exclude some forms of lending that do not conventionally form part of project finance. The industry structure in Norway makes lending to energy, natural resources, mining, power, transportation, infrastructure, and real estate sectors particularly significant for Norwegian banks. There is lending to these sectors that would fall under the preliminary definition of project finance that are not significantly different from traditional corporate lending in terms of risk. FNH recognises, however, that when the performance of the underlying project serves as the primary source of repayment the nature of risk associated with lending to such sectors may differ from lending to the corporate sector in general. Inter alia the risk of some projects will be high during construction and development, but falling significantly when the projects have come into use, thus having a 'vintage' or 'seasoning effect'. If the IRB treatment of project finance seeks to take account of the high risk of projects in early phases, it must also (to be incentive compatible) recognise the reduced risk many projects have in later phases.

FNH also feels strongly that all income producing/investment commercial real estate should not be excluded from eligible real estate collateral for corporate exposures. Completed multi-purpose commercial buildings, which can be can be used by third parties, should be recognised as eligible collateral in the IRB approaches for corporate exposures even if the property itself is the primary source for servicing of the debt. The same should be the case for rented residential buildings. It would be inconsistent to allow recognition of such collateral for corporate exposures in the standardised approach and not in the IRB approach.

Calibration of formula for derivation of risk weights, *cf. paragraphs 171-177*
The Committee's Working Group on Overall Capital has developed a note on issues related to Overall Capital, dated 21.02.2001. According to this note calibration of the formula for derivation of risk weights is based on both expected and unexpected losses. Expected losses are included in the calibration because some banks may include general reserves in part to meet their minimum capital requirements. Norwegian banks do not have a right to include such reserves in their own capital. In order to promote a level playing field among banks, we request the Committee to undertake a review of the definition of capital, with the aim of clarifying the definition of capital, shortly after completing the New Accord. Significant differences in the definition of capital may clearly influence the incentives banks may have to adopt the IRB approaches for capital adequacy purposes.

The note also explains that 'a measurement error adjustment' has been included in the absolute capital calibration process in order to remedy banks' possible measurement errors in PD estimates resulting in possible capital under-estimates. The proposed absolute capital amounts for corporate loans and thus retail loans are according to the note consistent with an adjustment for PD measurement error in the range of 20 %. FNH recognises that

measurement error in PD estimates may occur, but are in principal of the opinion that such risk constitute a potential operational risk that already is taken into account under the operational risk charge, and which also could be addressed under the second pillar of the New Accord. Furthermore, we find it hard to see that a PD measurement error of the magnitude of 20 % could persist over time in any bank across all PD buckets. It should also be taken into consideration that estimation errors would tend not to occur only one way, thus requiring much higher PD errors than 20 % for some exposures in order to create an average underestimation of 20 %. We would in regard to this topic also like to refer to the fact that the Committee in the proposed New Accord has placed great emphasis on the conservative behaviour of banks, cf. inter alia paragraphs 261 and 270. Such conservative behaviour could be undermined if the calibration of the risk weight function becomes very conservative.

According to the note the current calibration of the IRB risk weight formula also include a 30 % upward adjustment due to differences in the elements of Total Capital in the current Accord and the concept of 'loss-absorbing capacity' required to cover risk, as produced by the models used for calibration purposes. FNH does not agree with such an adjustment factor. Implicitly it discounts the value of tier 2 capital elements under the IRB approach, and thus creates a different treatment of capital elements in the standardised approach and the IRB approach. Furthermore, it implicitly takes up the discussion of the definition of Total Capital in the Accord, which has been said not to be a topic for this review. This topic should rather be subject of a separate review shortly after the New Accord has been established.

Treatment of guarantees, *cf. paragraphs 181- 190*
Our comments on application of the w-factor for guarantees under the IRB foundation approach are similar to those presented under the standardised approach above.

Loss Given Default (LGD), *cf. paragraphs 194-224*
We refer to our comments on application of the w-factor for financial collateral in regard to the standardised approach. The same comments apply to use of the w-factor in the IRB foundation approach.

Eligible collateral in the IRB foundation approach for corporate exposures is limited to the same eligible financial and physical capital as under the comprehensive approach for collateral in the standardised approach. Eligible physical collateral is thus limited to commercial real estate and residential real estate. The IRB advanced approach does not limit the scope of eligible collateral. Other physical collateral may therefore in principle be taken into account in the IRB advanced approach. From point of view of Norwegian banks an extension of eligible physical collateral in the IRB foundation approach would strongly be welcomed. Norwegian banks have long traditions in ship financing, where the quality of the collateral is a key issue in determining the risk of the loan. It would be most unfortunate if prudent estimates of such collateral only would be recognised for the limited number of large multinational banks that will be able to use the advanced IRB approach.

Methods whereby the most used physical collateral, other than real estate, could be recognised in the IRB foundation approach should be developed. Otherwise, there will be a significant divide between banks' practice and the future New Accord. If credit risk-mitigating techniques extensively used by European banks are not reflected in the final New Accord, our financial system will inadvertently be pushed towards a system with much more reliance on credit intermediation through the securities market. We urge the Committee to develop methods whereby the most used physical collateral, other than real estate, are recognised also in the IRB foundation approach.

Another issue regarding LGD for collateral is the high LGD value applied to exposures secured by eligible CRE and RRE collateral in the IBR foundation approach. Such collateral may at the lowest receive a LGD value of 40% in the IRB foundation approach for corporate exposures. This figure is, however, only applied to eligible real estate collateral exceeding the value of the exposure by 40%. Collateral below this threshold is only partly or not at all recognised. The limited difference between the 40% LGD figure for exposures secured 140% by eligible real estate collateral and the 50% LGD figure for unsecured senior claims, clearly illustrate the current lack of recognition of real estate collateral under the IRB foundation approach. We otherwise refer to the work by the European Mortgage Federation on exposures secured by CRE and RRE collateral.

Minimum requirement on update of borrowers rating, *cf. paragraph 247*
We agree with the Committee that banks using an IRB approach should be under an obligation to update relevant information on the borrower's financial condition, once such information is received. This obligation should be stated in general in the New Accord. The details should be left to the individual banks and their national supervisors. Paragraph 247 in the proposal for a New Accord goes thus to far in detailing absolute limits, which in some instances may be impracticable.

Oversight by the board of directors and senior management, *cf. paragraph 249*
According to paragraph 249 internal ratings should be an essential part in the reporting to board of directors, management committee, and senior management of a bank using an IRB approach. FNH concurs with the Committee in this issue. We do not, however, agree that the New Accord should prescribe explicit reporting frequencies to these parties. It would be to go to far in detailing internal procedures, which in some cases may be impracticable, and which should be under the oversight of the national supervisor.

Minimum requirement on internal audit, *cf. paragraph 253*
Norwegian banks are not under any legal obligation to establish and maintain a separate internal audit unit. National regulation allows banks to make use of external auditors for the purpose of carrying out internal audit functions. On this background FNH assumes that the requirement of an annual review by the internal audit, as described in paragraph 253, could be fulfilled by having the external auditor carrying out the review.

Operational requirements - use of real estate as collateral for corporate exposures, *cf. paragraph 319*
The proposal states that banks are expected to monitor the value of commercial real estate and residential real estate on a frequent basis and at a minimum once every year. It also states that the property should be evaluated periodically by a qualified professional no later than 3 years from the date of the last professional valuation, or when a maturity event occurs. Such procedures will impose significant additional costs for use of residential real estate collateral. The requirements are appropriate for commercial real estate collateral, but not for residential real estate collateral for corporate or for retail exposures. The extra cost will be unjustified from a risk perspective, and can lead banks to render such collateral ineligible rather than taking on the cost of adhering to the minimum requirements. There should be national discretion with respect to the operational requirements for low risk residential real estate collateral. Appropriate measures for residential real estate could include regular evaluation of collateral values on a portfolio level, taking into account changes since last evaluation in the general value of residential real estate.

LGD for bank exposures, *cf. paragraph 498*
Under the foundation approach to IRB for bank exposures the LGD factors for corporate exposures are applied to banks. Clearly, the 50% LGD for senior claims on banks is much too high. We understand that Bank of International Settlements has estimated a LGD of 20% for banks, and ask that a separate LGD factor for senior claims on banks more in line with this estimation is introduced in the final New Accord.

LGD for investing bank in securitisation, *cf. paragraph 541*
The Committee proposes to apply a 100% LGD on securitisation tranches issued by other institutions under the IRB approaches. This number is too conservative and should be set below 50 %.

3. OPERATIONAL RISK / OTHER RISK

Calibration of the operational risk charge, *paragraph 21 in the supporting document on Operational Risk*
We welcome the Committee's recognition that the capital charge for operational risk needs more accurate calibration. In the supporting document the Committee states that the starting point for the calibration this far has been an estimation by a small sample of banks, which indicates that operational risk accounts for 20% of economic capital. We wish not to argue that 20% is too high for large international banks dealing in complex instruments. We are, however, concerned that the 20% add on for operational risk, would be unjustified for banks operating in less complex markets and which have a more simple structure than

the largest international banks. Norwegian banks that will be operating under the standardised approach to credit risk will face a capital charge for credit risk in the banking book not significantly different from the current capital charge for the banking book. Thus, the operational risk add on would be seen as an additional "tax" on their activities, which is not justified from an economic risk perspective.

We have above argued that the w-factor applied to credit risk mitigation techniques creates a double counting of operational risk. If the w-factor is kept in the final New Accord, it is important that the level of the separate operational risk charge is adjusted down in order not to create a double counting of risk.

FNH would also like to state that we support in principle the development of a spectrum of methodologies for operational risk. We find it especially important that the regulatory requirements for operational risk are constructed such that institutions have incentives to reduce the operational risk. The proposed standardised approach gives no incentives to reduce operational risk. The only way the operational risk charge can be reduced in this approach is to change the business mix or the level of activity. In our view, an 'advanced' standardised approach should developed taking into account factors relating to the quality of internal control and management of operational risk, diversification of operational risk across business lines, and employment of operational risk mitigation techniques (risk transfer). This view also reflects an uncertainty on our part of the quality of the current internal-models for operational risk.

Business lines in the standardised approach, *cf. paragraph 553*
We would like to see the introduction of a separate business line for agency services (including custody) and a business line for insurance related activities that banks carry out.

Interest rate risk in the banking book, *cf. paragraph 630*
FNH is surprised that the previously proposed interest rate risk charge for the banking book in pillar one has been made a pillar two issue. This is particularly surprising taking into consideration on the one hand the significant contribution to total risk that interest rate risk in the banking book may constitute, and on the other hand the complexity and fine tuning, which has been sought for the other risk charges in the first pillar. The suggested application of national minimum capital requirements, on top of the requirements in the New Accord, would not contribute to the goal of creating level playing fields for banks. FNH would therefore like to see the Committee giving clear supervisory guidance to national supervisors on the application of national requirements, including a recommendation on a 'de minimis exemption' for institutions with very limited net interest rate risk.

Given that the issue of a capital charge for interest rate risk is left to national regulation it is important that the overall capital requirement is calibrated in such a way that it does not implicitly include a factor for interest rate risk.

Yours faithfully,

Arne Skauge
Managing Director

Tor A. Hvidsten
Deputy Director

SPAREBANK
FORENINGEN

Universitetsgt. 8
Postboks 6772 St. Olavs plass
0130 Oslo
Telefon: 22 11 00 75
Telefax: 22 36 25 33

Kredittilsynet

Postboks 100 Bryn
0611 Oslo

09. MAI 2001
KREDITTILSYNET
Sak nr. 200101300-14
Arkiv: 501
Purredato:

RKS F2

Deres ref. 2001/1300 Vår ref. 200000157- EJ Oslo 8.mai 2001

Høringsuttalelse vedrørende forslag til nye retningslinjer for beregning av kapitaldekning fra Baselkomiteen

Vi viser til Kredittilsynets brev av 29.1.2001 der det bes om Sparebankforeningens uttalelse til Baselkomiteens forslag til nye retningslinjer for beregning av kapitaldekning.

1. Generelle kommentarer

Sparebankforeningen vil i denne omgang primært nøye seg med å knytte enkelte prinsipielle kommentarer til forslaget. Mye av rammen for regelverket må antas være på plass i det foreliggende forslaget basert blant annet på de tilbakemeldinger Baselkomiteen mottok under den forrige høringsrunden. Det er for øvrig vanskelig å knytte konkrete merknader til forslaget så lenge kalibreringen av en rekke sentrale parametre ennå ikke er bestemt, og som følge av at resultatene fra "the quantitative impact study", verken nasjonalt eller internasjonalt, foreligger.

Foreningen er i det store og hele fortsatt positive til det revideringsarbeidet som har funnet sted. Det foreslåtte regelverket vil kunne sikre at kapitalkravet i større grad avspeiler kredittrisikoen i den enkelte bank. Vi er derimot mer usikre på om reglene vil bidra til like konkurransevilkår blant bankene.

Sparebankforeningen støtter forslaget om at flere enn de mest sofistikerte bankene skal kunne benytte interne ratingsystemer (IRB) for beregning av kapitalkrav. En rekke banker har i dag kredittvurderingssystemer som kvantifiserer kredittrisikoen mer korrekt enn den relativt enkle standardmetoden. IRB vil dermed sikre en bedre sammenheng mellom kapitalkravet og den økonomiske risikoen i hver enkelt bank, noe som er det overordnede målet for gjennomgangen av regelverket. Selv om Sparebankforeningen støtter forslaget om å gjøre IRB tilgjengelig for en større gruppe av banker enn det som tidligere var foreslått, mener vi det er galt å gi så sterke stimulanser til bruk av den mest avanserte metoden (Advanced Approach) i form av reduserte kapitalkrav, som på sikt skal kunne anvendes av de største og mest avanserte bankene. Foreningen ønsker ikke at utformingen av nye kapitaldekningsregler skal bidra til å påvirke strukturen i bankmarkedet i form av sterke insentiver til stordrift. Kapitaldekningsreglene bør kun ha som oppgave å sikre at bankene har ansvarlig kapital til å stå imot underskudd. De største bankene er gjennomgående de som er svakest kapitalisert.

Disse representerer dessuten klart den største trussel mot den finansielle stabilitet, og det finnes relativ fersk empiri på at avanserte styringssystemer i seg selv ikke innebærer en garanti mot betydelige tap. Vi finner det derfor underlig at det nye regelverket skal bidra til at de største bankene kan redusere sin soliditet vesentlig.

Standardmetoden vil bli benyttet av de fleste norske sparebanker, og vi tror heller ikke det på sikt vil være aktuelt for disse å gjøre bruk av IRB. Det er også grunn til å tro at standardmetoden vil ha stor utbredelse internasjonalt, i alle fall innen EØS-området. Det er derfor viktig at det utvikles en robust standardmetode som bør kunne ha anvendelse i mange år fremover.

Innenfor standardmetoden vil de foreslåtte risikovekter i liten grad avvike fra det som gjelder i dag. Så lenge få norske foretak er ratet, innebærer dette at nesten alle bedriftslån fortsatt vil vektes 100 prosent. Med unntak av boliglån, vil også engasjementer i personkundemarkedet vektes med 100 prosent. En mer korrekt sammenheng mellom risiko og kapitalkrav må derfor oppnås ved hjelp av risikoreduserende teknikker i form av pant, garantier, kredittderivater og netting på balansen. Når det gjelder pant, som sammen med garantier trolig vil kunne ha størst betydning for norske banker, åpner forslaget for at pantstillelse av finansielle eiendeler med god likviditet kan redusere beregningsgrunnlaget for kapitaldekningen. Det er ikke åpnet for utvidet mulighet for risikoavdekning ved bruk realpant.

Bruk av finanspant har foreløpig liten utbredelse i Norge. Med tilnærmet like vekter og begrenset virkning av risikoreduserende teknikker, tror vi ikke standardmetoden, med mulig unntak for vektingen av interbankfinansiering, vil medføre nevneverdig endring i beregningsgrunnlaget for kredittrisiko for norske sparebanker I så fall er lite oppnådd i forhold til ambisjonen om å gjøre regelverket mer følsomt for risiko. Men det kan selvsagt ikke utelukkes at regelverket på sikt vil påvirke bankene til å endre sin praksis i retning av økt bruk av de foreslåtte teknikker.

Sparebankforeningen er blitt gjort kjent med at minst én europeisk sentralbank vurderer å benytte sin regnskapsdatabase som kilde for input for banker til kapitaldekningsberegninger. Databasen vurderes benyttet på den måten at vedkommende sentralbank enten påtar seg rollen som eksternt ratingselskap i forhold til bruk av standardmetoden eller som kilde med historiske data når bankene skal fastslå sannsynligheter for tap (PD) ved bruk av intern rating. I forhold til førstnevnte bruksområde vil dette kunne fange opp gruppen av foretak som vil vektes 20 prosent, 50 prosent eller 150 prosent, men som alternativt, pga. manglende rating, vil måtte vektes 100 prosent. På den måten gjøres bruk av de muligheter til risikodiffensiering som ligger i standardmetoden. For norske banker kan det reises spørsmål om Norges Banks database kan utnyttes på en liknende måte, enten i regi av Norges Bank eller andre. Dette spørsmålet bør etter vårt syn vurderes nærmere.

2. Rekkevidden for regelverket

Sparebankforeningen gir sin støtte til at regelverket også skal gjelde for holdingselskaper. Begrepet "predominantly banking groups" bør imidlertid gis en presis definisjon.

At kapitaldekningsreglene også gjelder for delkonsern og for hver enkelt bank, er selvsagt.

3. Pilar I

3.1 Standardmetoden

Fordringer på banker

Baselkomiteen har valgt å opprettholde sitt forslag når det gjelder behandlingen av fordringer på banker. Dette innebærer to alternative måter for vekting. I metode 1 vektes bankfordringer én klasse høyere enn vektingen til staten banken er hjemmehørende i. Under metode 2 bestemmes vektingen av oppnådd rating, mens banker uten rating gis en vekt på 50 prosent. Sistnevnte metode innebærer dessuten at fordringer med en løpetid på 3 måneder eller kortere kan vektes med 20 prosent. Nasjonale myndigheter må i sin implementering av retningslinjene velge én av metodene.

Sparebankforeningen er av den oppfatning at forslaget om to alternative metoder, der det skal være opp til hvert enkelt land å velge metode, lett vil kunne skape konkurransemessige vridninger. Denne vridningen kan illustreres med følgende eksempel. Anta at land A implementerer metode 1, mens land B implementerer metode 2. Under metode 2 vil flesteparten av bankene ha en høyere vekt enn under metode 1. Dette har sin forklaring i at få banker er ratet, og at blant de banker som er ratet, vil kun et fåtall oppnå bedre rating enn A+. Samtidig vil solid rating for den norske stat sikre 20 prosent vekt under metode 1. Banker i land B vil da normalt kunne finansiere lån over tre måneder billigere hos banker i land A enn i sitt hjemlige interbankmarked. Dette skjer fordi långiverbankene i land A ikke trenger stille like mye ansvarlig kapital bak sine lån til andre banker, som det banker i land B må gjøre. Det er liten mening i at kapitaldekningsreglene skal gi en slik arbitrasjemulighet. Sparebankforeningen går derfor i mot at revidert Capital Accord skal inneholde to alternative metoder for vekting av bankfordringer.

Når det gjelder preferert metode, vil Sparebankforeningen, i likhet med i forrige høring, uttrykke vår klare støtte til metode 1. Fordelen med denne metoden er at den anerkjenner den nære sammenhengen mellom landets økonomiske situasjon og kredittverdigheten til bankene. Norske banker er i liten grad eksponert mot annet enn norsk økonomi.

Hovedproblemet med metode 2 er at få norske sparebanker er ratet. Det er urimelig at kapitaldekningsreglene skal bidra til ulike finansieringskostnader, uten hensyntagen til den enkelte banks soliditet og økonomiske situasjon forøvrig.

Et annet problem ved metode 2, er det sterke insentivet som ligger til kortsiktig finansiering, og som isolert sett kan bidra til å øke likviditetsrisikoen i bankene.

3.2 Interne Ratingsystemer

Sparebankforeningen har merket seg forslaget om at det for enhver kombinasjon av sannsynligheten for tap/tap gitt mislighold (PD/LGD), er lagt opp til at risikovektene knyttet til såkalte "retail"-lån, skal være halvparten av de som gjelder for lån til "corporates".

Begrunnelsen er at tapene her er vesentlig lavere. Det er foreslått en definisjon av "retail" som i praksis vil dekke engasjementer med personer og små foretak.

Sparebankforeningen mener det er behov for en mer presis definisjon av begrepet "retail". Dersom det er slik at boliglån er holdt utenfor "retail"-begrepet, stiller vi oss tvilende til at det er lavere tap her enn ved lån til "corporates". Det er dessuten vanskelig å ha en klar oppfatning om hvorvidt små foretak bør behandles som "retail" eller "corporates".

Vi vil fremheve at en god måte å sikre at tapene knyttet til personer og små foretak blir lave, er gjennom tett oppfølging, kunnskap om og nærhet til kunden. Dette er kvaliteter som vanskelig fullt ut kan ivaretas innenfor automatiserte kredittvurderingssystemer. Foreningen vil minne om at lån til "retail" vil måtte vektes 100 prosent innenfor standardmetoden. Det er standardmetoden som vil bli benyttet av de bankene som har størst kunnskap om og nærhet til kundene i "retail"-markedet. Det virker derfor som et paradoks at et fortrinn i form av lavere kapitalkrav skal gis til de banker som ikke har et slikt fortrinn.

Sparebankforeningen vil også bemerke at gjeldende kapitaldekningsregler er ment til å stå imot mulige underskudd. De forventede tapene skal dekkes av tapsavsetningene i tråd med kravene i regnskapslovgivingen. I IRB-metoden er kapitalkravet foreslått kalibrert slik at det dekker både forventede og "ikke-foventede" tap. Dette innebærer en skjerping av kapitalkravet, som det er vanskelig å se begrunnelsen for.

3.3 Risikoreduserende teknikker

Prinsippet om "haircut" ved bruk av finansiell pant er fornuftig fordi det er en risiko for at verdien på pantet vil kunne svinge både på grunn av utstederspesifikke forhold eller som følge av en generell reduksjon av markedsverdier. Vi vil likevel peke på at det ikke gir mening å pålegge "haircut" i tilfelle det er stillet pant i form av "cash on deposit" i långiverbanken.

Et element i beregningen av en slik "haircut" er ved tilfeller der pantet er i annen valuta. Sparebankforeningen minner om at kapitalkrav for dekning av valutarisiko, både for handelsporteføljen og bankporteføljen, allerede er dekket av reglene i markedsrisikoreguleringen. Reduksjon i verdien av risikoavdekningen som følge av pantet er i en annen valuta, vil dermed føre til at valutarisikoen blir beregnet to ganger.

Foreningen har også merket seg at risikoavdekningen skal reduseres med en faktor "w". Denne er opplyst å skulle dekke en slags residual risiko. Sparebankforeningen mener at dekningen for "øvrig risiko" bør være ivaretatt gjennom kapitalkravet for operasjonell risiko.

3.4 Operasjonell risiko

Baselkomiteen definerer operasjonell risiko som risikoen for direkte eller indirekte tap pga. inadekvat eller mangelfull internkontroll, svikt hos personalet, systemer eller som følge av eksterne hendelser. Kapitalkravet beregnes i den enkleste metoden som en gitt prosent multiplisert med bankens inntekter. I en noe mer avansert metode beregnes diverse indikatorer med utgangspunkt i bankens ulike virksomhetsområder. Indikatorene blir fastsatt enten ut fra inntektssiden eller gjennomsnittlig forvaltet kapital. Kapitalkravet beregnes ved å multiplisere

betafaktorene med de tilhørende indikatorene. Verken verdiene på betafaktorene eller prosentsats i den enkleste metoden, er bestemt.

Sparebankforeningen er enig i at operasjonell risiko er en sentral risiko i bankvirksomhet. Vi mener likevel at denne risikoen er av typisk kvalitativ karakter, og som vanskelig lar seg kvantifisere. Den mest egnede måten å dekke operasjonell risiko på er, etter vår mening, ved hjelp av internkontroll, forsikring og lignende. Det foreliggende forslaget gir ingen stimulans til banker til å sette av store ressurser til internkontroll. Et gitt prosentvis påslag beregnet med utgangspunkt i inntektene og forvaltet kapital gir ingen mening i forhold til å fange opp den enkelte banks operasjonelle risiko. I så fall bør kravet like gjerne kunne ta utgangspunkt i beregningsgrunnlaget for kapitaldekningen.

Sparebankforeningen mener at behandlingen av operasjonell risiko passer best inn under pilar 2 der det foretas en mer grundig og samlet gjennomgang av forholdet mellom soliditet og risiko.

4. Pilar 2

Sparebankforeningen er enig i at Pilar 2 bør utgjøre en sentral del av den nye kapitaldekningsreguleringen. Spesielt vil dette være tilfelle etter at det ble åpnet for utvidet adgang til bruk av IRB for beregning av kapitalkrav.

Vi har merket oss at Baselkomiteen ikke mener det er behov for harmonisering av tilsynsmyndighetenes praktisering av Pilar 2. Begrunnelsen er at det eksisterer juridiske forskjeller, ulikheter i tilsynspraksis med mer, som gjør det vanskelig å etablere en felles standard. Komiteen oppfordrer derimot tilsynsmyndighetene til utveksling av erfaringer, og antar at det etter hvert vil utvikle seg en felles praksis på området.

Sparebankforeningen deler ikke dette synspunktet, og vi mener at det uttrykte ønsket om harmonisering er for vagt. Pilar 2 handler grovt sett om at banken skal ha på plass rutiner og en strategi for å sikre at dens soliditet er tilpasset risikoen, at tilsynsmyndighetene skal gjennomgå bankens vurderinger foruten at tilsynsmyndighetene skal kunne kreve at banken har en høyere kapitaldekning enn minimumskravet. Det er vanskelig å se hvordan det vil være mulig for Baselkomiteen å oppnå målet om at reglene skal bidra til å fremme konkurranselikhet, dersom disse sentrale elementene i reguleringen ikke gjøres forpliktende for alle land.

Foreningen tror at både tilsynsmyndigheter og banker vil være tjent med at det gis relativt presise standarder på dette området. Vi antar at det vil kunne bli vanskelig for tilsynsmyndighetene å oppnå tilstrekkelig legitimitet blant bankene for sitt arbeide med Pilar 2, dersom dette ikke er basert på en gitt internasjonal standard. Spesielt vil dette være tilfelle ved eventuelle pålegg om at banken må øke sin kapitaldekning.

Sparebankforeningen har merket seg forslaget om at eventuell renterisiko i bankporteføljen skal håndteres under pilar 2. Vi vil bemerke at det eksisterer velprøvde metoder for beregning av renterisiko. Foreningen har derfor vanskelig for å forstå hvorfor denne risikoen ikke skal inngå i pilar 1.

5. Pilar 3

Sparebankforeningen har få merknader til forslaget til pilar 3.

De kravene som er foreslått gjelde under pilar 3 er antakelig langt på vei ivaretatt i eksisterende norske regnskapskrav for børsnoterte selskaper. Vi vil likevel generelt peke på at det er viktig at kravene etter denne pilaren ikke blir så omfattende at de blir lite fokuserte.

En mulig løsning er å kreve ett sett av krav til dokumentasjon av alle banker, mens de bankene som anvender IRB, pålegges ytterligere krav til offentliggjøring. I førstnevnte tilfelle kan kravene være å offentliggjøre basis informasjon om sammensetningen av beregningsgrunnlaget og den ansvarlige kapitalen, mens den mer omfattende delen eksempelvis også kan inneholde elementer som bekriver bankens egne vurderinger av "economic capital".

Den nye reguleringen inneholder ulike metoder for å kalkulere beregningsgrunnlaget for kapitaldekningen. Dette innebærer at det ikke lenger vil være mulig å sammenligne bankers "BIS-ratio". Etter Sparebankforeningens oppfatning bør det vurderes å kreve at alle banker under pilar 3 publiserer kapitaldekningstall beregnet etter standardmetoden.

Med vennlig hilsen
for SPAREBANKFORENINGEN I NORGE

Einar Forsbak