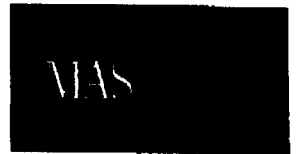


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5 June 2001

Managing Director

Mr William J McDonough  
Chairman  
Basel Committee on Banking Supervision  
c/o Federal Reserve Bank of New York  
33 Liberty Street  
New York  
NY 10045  
United States of America

Dear *WJ*,

**COMMENTS ON THE SECOND CONSULTATIVE PACKAGE OF  
THE NEW BASEL CAPITAL ACCORD**

May I on behalf of the Monetary Authority of Singapore ("MAS") thank the Basel Committee on Banking Supervision ("Committee") for the opportunity to comment on its proposals for the New Basel Capital Accord ("New Accord"). The MAS welcomes the key thrusts of the New Accord, and congratulates the Committee for its excellent work.

2 The proposals mark a significant improvement over the 1988 Accord. First, they establish a more comprehensive and risk-sensitive capital adequacy framework for banks. Second, by better aligning regulatory and economic capital, the New Accord will reduce the scope for regulatory arbitrage and foster more disciplined capital management by banks. Third, by recognising new risk measurement and management practices that have evolved in the industry over the past two decades, the New Accord provides strong incentive for banks to develop more effective internal capabilities and systems to mitigate risk.

3 I shall therefore restrict my comments to two issues of significant concern: recognition of real estate collateral for credit risk mitigation, and incentive-compatibility of the New Accord.

### Real Estate Collateral

4 First, real estate collateral. While the taking of collateral can never be a substitute for rigorous credit evaluation and ongoing credit monitoring, good collateral is an effective tool for credit risk mitigation. The experience of banks in Singapore suggests that the Loss Given Default ("LGD") for secured credits currently proposed by the Committee understates the effectiveness of real estate collateral in mitigating credit risk. Empirical evidence from past property market downturns in Singapore supports this observation. Assuming a 40% decline in property prices, the expected LGD for a loan that is 100% secured by real estate is 30%; for a loan that is 160% collateralised, the expected LGD is 13%. These estimates are much lower than the 43% and 40% corresponding LGD figures implied by the Committee's proposal under the IRB approach.

5 We request the Committee to allow national supervisors to recognise the lower risks and apply a lower floor for the LGD of secured credits under the IRB approach, where country-specific empirical evidence substantiates the application of a lower LGD at higher levels of collateralisation. We also request that the Committee re-consider, under the standardised approach, recognising real estate collateral subject to appropriate haircuts as determined by national supervisory authorities.

### Incentive-compatibility of the New Accord

6 Second, the incentive-compatibility of the New Accord. The relative risk weights between the standardised and IRB approaches with respect to high-risk assets and undrawn commitments have significant implications for Singapore and possibly other jurisdictions. Owing to the much higher risk weights under the IRB approach for high-risk assets, riskier assets could gravitate to institutions using the standardised approach. IRB banks will also be at a competitive disadvantage and could be priced out of certain markets, such as in loans to small and medium-sized enterprises. This creates perverse incentive for banks with high-risk assets to remain with the standardised approach instead of moving towards the IRB approach. We propose that the existing gap in risk weights for high-risk assets between the standardised and IRB approaches be narrowed to the extent possible.

7 For undrawn commitments under the standardised approach, Exposure At Default ("EAD") is 20% for commitments that are of less than 1 year maturity and 50% for those that are of more than 1 year maturity. Under the IRB foundation approach, the EAD is 75% regardless of maturity. This difference weakens the incentive for banks to move to the IRB foundation approach. Adjustments will be necessary in the EAD treatment for undrawn commitments in order to strengthen this incentive.

#### Conclusion

8 A more detailed comment is attached in Annex 1. We recognise that the Committee will be receiving a flood of comments and suggestions, many pulling in different directions. It will not be possible to fashion a final set of proposals that accommodates all views. I should note, however, that the concerns with respect to real estate collateral and undrawn commitments pertain to features of banking that are present not only in Singapore but also other countries in the region.

9 The MAS is confident that the Committee will deliver a judicious and balanced final Accord and provide supervisors and banks the necessary guidance for its practical implementation. The MAS is keen to contribute to and assist the Committee in whatever way it can to advance this important initiative for promoting a sound and resilient banking system.

Yours sincerely,



THARMAN SHANMUGARATNAM



cc Ms Daniele Nouy,

Secretary General, Basel Committee on Banking Supervision



**Annex 1****MAS FEEDBACK TO THE BASEL COMMITTEE ON  
THE NEW BASEL CAPITAL ACCORD****Recognition of Real Estate Collateral for Credit Risk Mitigation**

1 The MAS has received strong and persuasive feedback from Singapore banks that, based on their experience in the Singapore market, the proposed treatment of real estate collateral for credit risk mitigation under the New Accord is overly conservative. Under the standardised approach, physical collateral such as real estate is not recognised for credit risk mitigation. Under the IRB approach, capital relief for real estate collateral is very limited. An increase in the collateral-to-exposure ratio ("C/E") from the lower threshold level of 30% to the upper threshold level of 140% reduces the associated Loss Given Default ("LGD") from 50% to 40%. This ten-percentage point reduction in LGD appears too small, and does not adequately recognise the difference in risk between an unsecured loan and an over-collateralised loan where the collateral satisfies stringent qualitative factors for eligibility. Moreover, under the current proposal, credit risk mitigation obtained via additional collateralisation beyond the 140% threshold C/E level will not be recognised, as the 40% LGD represents a floor.

2 Banks in Singapore, as in many other markets, typically try to take some form of collateral for their loans. Indeed, in lending to higher risk borrowers such as small and medium enterprises ("SMEs"), collateral is almost invariably taken to mitigate credit risk. An estimated 65% of Singapore banks' loans to corporations and businesses are secured by collateral; for loans to SMEs, the proportion is higher, at almost 90%. Of the secured loans to SMEs, approximately 85% is secured by real estate collateral.

3 While the taking of collateral can never be a substitute for rigorous credit evaluation and ongoing credit monitoring, good collateral is an effective tool for credit risk mitigation. The experience of banks in Singapore suggests that the LGD for secured credits currently proposed by the Committee understates the effectiveness of real estate collateral in mitigating credit risk. Empirical evidence from past property market downturns in Singapore supports this observation. Assuming a

## Annex 1

relatively severe downturn - 40% decline in property prices and a work-out period of 2 years<sup>1</sup>, a loan that is 30% secured by real estate (C/E = 30%) would have an expected LGD of 50.4%.<sup>2</sup> This is close to the 50.0% proposed under the New Accord. However, for a loan that is fully secured by real estate (C/E = 100%), the expected LGD is 30.2%; for a loan where C/E = 160%<sup>3</sup>, the expected LGD is 12.9%. This is much lower than the 42.9% and 40.0% corresponding LGD figures implied by the Committee's proposal under the New Accord.

4 We seek the Committee's clarification on how the 40% LGD floor was determined. We would also request that the Committee consider granting national supervisors the discretion to lower this floor where country-specific factors (e.g. time taken to foreclose on real estate collateral, property price volatility, and bank practise with regard to collateral valuation) substantiate the application of a lower LGD at higher levels of collateralisation. In the case of Singapore, we would consider the appropriate floor for the LGD to be at a level corresponding to a C/E of 160%. We take 160% C/E as the upper threshold because banks in Singapore typically require this amount of collateral in financing of real estate<sup>4</sup>. At C/E of 160%, an LGD of 15% will be a conservative estimate of the floor for Singapore (please see para 3). A linear function could be used to calculate the appropriate LGD for C/E values between 30% and 160%<sup>5</sup>.

<sup>1</sup> During the last 25 years, the largest decline in the residential property price index in Singapore over any two-year period was 33%. The corresponding figures for office space and shop space were 42% and 40% respectively. A two-year period is a conservative estimate for the time taken to foreclose on real estate collateral in Singapore. In addition, most Singapore banks perform in-house or independent mark-to-market valuation of collateral at least once a year. Where collateralisation has fallen below the targeted levels, and depending on the credit standing of the borrower, banks may require margin top-ups, additional collateral from the company or its directors, or alternatively reduce the facility granted. Thus, C/E values are kept current, and will reflect any deterioration in property collateral values.

<sup>2</sup> This assessment is based on the following assumptions: (1) a two-year period between default and foreclosing on the property; (2) a carry interest cost of 4.5% per annum during the foreclosure period; (3) agency and legal charges of up to 2% of the collateral value; and (4) 50% LGD for the unsecured part of the loan.

<sup>3</sup> C/E of 160% represents the level of collateral level that banks in Singapore would typically require for financing real estate.

<sup>4</sup> Indeed, in lending to certain high risk sectors, banks have required as much as 100% overcollateralisation (i.e. 200% C/E).

<sup>5</sup> For example, where  $30\% < C/E \leq 160\%$ ,  $LGD = [50\% - (C/E - 30\%)/130\% * 35\%]$ .

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5 Banks are currently collecting and analysing their internal LGD data for collateralised loans. Such data will better illustrate the loss characteristics of collateralised loans and allow more precise calibration of the appropriate LGD levels. The MAS will be happy to provide relevant data to the Committee once the banks have completed their work in this area.

6 For the standardised approach, we would request that the Committee reconsider widening the definition of eligible collateral to include real estate. Such recognition could be accompanied by a suitable haircut to allow for property price depreciation during the work-out period. We suggest a haircut of 30% and 25%<sup>6</sup> for loans collateralised by commercial real estate and residential real estate respectively, taking into account the greater volatility in commercial real estate prices (please see footnote 1). This should provide more appropriate recognition of, and incentive for, prudent risk management practices in lending to higher risk borrowers.

**Incentive-compatibility of the New Accord**

7 The IRB approach provides a wider range of risk-weights, and one that is more reflective of the risk profile of borrowers, than those under the Standardised approach. We therefore support the Committee's intention to build into the New Accord incentives for banks to move to the IRB approach. This would suggest that the risk weights under the IRB approach be lower than those under the Standardised approach across the entire spectrum of asset credit quality<sup>7</sup>. This would not appear to be the case under the current proposals. There are differences in the treatment between the standardised and IRB approaches in two areas which warrant attention: high-risk assets and undrawn commitments. These are discussed below in turn.

<sup>6</sup> At 100% C/E, i.e. for fully collateralised loans, a 40% and 30% decline in real estate prices will result in a LGD of 31% and 26% respectively.

<sup>7</sup> In the case of well-diversified banks, we recognise that this condition may not be necessary to encourage adoption of the IRB approach. For such banks, the capital savings for low-risk assets could outweigh the capital increments required for high-risk assets under the IRB approach. However, for banks who are not so well-diversified, this is a necessary condition.

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8 First, the risk weight for the worst risk category under the IRB approach is as much as four times the 150% risk weight for high-risk assets under the standardised approach. Banks with predominantly risky assets will have incentive not to move to the IRB approach. Second, these banks will likely be able to price risky assets more competitively than banks using the IRB approach. We could then expect riskier assets to gravitate to institutions using the standardised approach. This creates perverse incentive for banks with high-risk assets to remain with the standardised approach instead of moving towards the IRB approach.

9 This issue has implications that are more than theoretical for Singapore and possibly other jurisdictions. Although it is the MAS' intention to require all significant Singapore banks to work towards adopting the IRB approach, it is less clear that smaller institutions should also be made to do so, in particular where the size of their operations does not justify the investment. However, these smaller players compete with the significant banks in servicing SMEs. Under the existing calibration of risk weights, banks in Singapore adopting the IRB approach will clearly be at a competitive disadvantage against these smaller players and could potentially be priced out of certain markets, for example, the SME market.

10 To create the incentive for institutions to move towards more sophisticated approaches regardless of the riskiness of their portfolios, we propose that the existing gap in risk weights for high-risk assets between the standardised and IRB approaches be narrowed to the extent possible. We should naturally be careful that in doing so, we do not increase sharply the capital requirements for the vast majority of banks in the world that will still be using the standardised approach. This would not be in line with the Committee's objective of having unchanged capital requirements under the standardised approach for an internationally active bank.

11 The Committee could therefore consider lowering slightly the risk-weights under the IRB approach across all risk categories in conjunction with increasing the risk weights for higher risk assets under the standardised approach and decreasing them under the IRB approach. Careful calibration will of course be required to

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ensure that the lowering of minimum capital requirements under the IRB approach does not compromise prudent lending practise.

12 The other issue with regard to the incentive-compatibility of the IRB approach stems from the difference in treatment of Exposure At Default ("EAD") under the standardised and IRB Foundation approaches for undrawn commitments. Under the standardised approach, EAD is 20% for commitments that are of less than 1 year maturity and 50% for those that are of more than 1 year maturity. Under the IRB foundation approach, the EAD is 75% regardless of maturity. This difference would weaken the incentive for banks to move from the standardised approach to the IRB foundation approach. Adjustments will be necessary in the EAD treatment for undrawn commitments in order to remove the existing disincentive for banks to move towards the more risk-sensitive IRB Foundation approach.