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Dear Mr. McDonough

Comments on the Second Consultative Package of the New Capital Accord

Following the release of the more detailed capital adequacy framework in January by the Basel Committee on Banking Supervision, we have had extensive consultation with our banking industry. This exercise has proved to be extremely helpful in promoting the understanding of the future capital regulation and sharpening the awareness of our banks to further improve their overall risk management system. Our present capital regulation is largely based on the 1988 Capital Accord. We know how challenging it is to improve our system with the new Capital Accord as a benchmark. The following comments offered here reflect both the views of the central bank and the banking industry in China.

General comments

We would like to reiterate our strong support for the objectives of the new capital adequacy framework characterized by the three pillars. By way of integrating minimum capital requirements with supervisory review and market discipline, the new Capital Accord helps to codify the successful supervisory approach to capital regulation that is already in place in major markets. However, a number of issues need to be resolved before the underlying principles and, particularly, the essential provisions of the new Accord can be effectively adopted by more and more countries out the G-10 in the near future. Further, banks in emerging markets still have a long way to go in order to improve their overall risk management system and supervisors in these countries are also under serious resource constraint. The difficulties in these areas should be not underestimated when promoting the adoption of the new Capital Accord.

We understand that the new Capital Accord is intended for a broader application. As the consultative papers state, the principles embodied in the three pillars of the new framework are generally suitable to all types of banks around the world. Many banks

in other countries will be expected to use the standardized approach to calculate minimum capital requirements, and all significant banks will adhere to the new Accord in a period of time. It is true that the new Accord offers a number of options for countries to choose from. However, it seems to fall short of providing enough alternatives for banks in emerging markets. Indeed, the complexity of the new Accord, even for the standardized approach, weakens its general application. In the absence of many essential conditions, the implementation of the new Accord will not be feasible for many non-G10 countries.

We also believe that the new proposals, as they stand now, will be unlikely to achieve the same objectives for non-G10 countries, if implemented, simply because they basically address the need of the large and complex banks in G10 countries. For example, the implementation of the new Accord in non-G10 countries, including China, will definitively increase the overall level of capital, either by the use of standardized approach or the internal-ratings based approach. Also, the calibration of absolute capital under the standardized approach will not be so much risk-sensitive because almost all corporate claims (below BBB or unrated) will receive 100% risk weight. Yet, we all know that seldom do sovereigns in emerging markets have a rating above BBB and let alone corporates registered in these jurisdictions. Perhaps, the Basel Committee should explore the possibility of building an equally robust but simplified standardized approach that can be useful for applications across the world, preferably with the direct participation of emerging markets.

Standardized approach

Our consultation with the banking confirms our concern for the use of external ratings agencies for capital purposes. This approach is not workable for many emerging markets. Take China for example. There are very few ratings agencies and corporates that they have covered are few in number. There is also a good reason to believe that their ratings are not necessarily reliable. Changing this situation will take a long time. On the other hand, the use of international rating agencies is also questionable. In many cases, these ratings agencies do not have a balanced view of emerging markets; it is thus difficult for them to generate fair and reliable ratings. Given all these concerns, our banks have little interest in engaging rating agencies even if the cost is less prohibitive; instead they prefer the use of internal ratings approach as a meaningful alternative, although the challenge to use IRB for capital regulation should not be underestimated.

We are concerned about the continued use of different risk weighs assigned to claims on sovereigns denominated in foreign currencies and domestic currency. The proposal fails to take into account the political reality in non-G10 countries and it overlooks the overall responsibility of the supervisor in maintaining overall financial stability. We certainly share the Committee's view that country risk or transfer risk needs to be taken into account in international transactions. However, in many emerging markets

the supervisor can hardly assign a higher risk for securities denominated in foreign currencies and a lower or zero risk weight for securities denominated in local currency issued by the same government. This would undermine the reputation of the government and directly set the supervisor on the course of collision with the Ministry of Finance, which likely enjoys a higher status in the government. At least, this issue should be recognized and properly addressed in the proposals and some flexibility should be provided at the national discretion.

The recognition of collateral in the current proposal seems to be too narrow. The proposal only accepts cash and securities rated BB- by sovereigns, securities rated BBB- and above by banks and securities firms etc.. In emerging markets where financial markets are less developed by definition, physical collateral, covering both real estate and other assets, is often used and over-collaterization is common. Moderate as it can be, capital regulation should encourage secured lending by offering some capital relief for physical collateral. In so doing, it will help better allow for differentiation of risks. Perhaps, this would need to have another risk bucket of, say, 75%.

We acknowledge the challenge to accurately measure operational risk but agree that there should be a regulatory capital charge on operational risk. In many emerging markets, operational risk can be very high given the absence of a well-defined legal framework and adequate internal control systems. However, the proposed 20% of current minimum regulatory capital seems to be excessively high. Perhaps this also is another area that highlights the difference between G10 and non-G10 banks in general. Like many other emerging markets, we separate commercial banking with investment banking and insurance business. Banks here provide traditional commercial banking services with almost no transactions in derivatives or involvement in other complicated financial instruments. Further, banks' fee-based income remains small. Therefore, capital charge for operational risk needs to be reduced. And some national discretion could also be considered so as to take into account the country and bank specific conditions. We also believe that the definition of operational risk needs to be further reviewed. Our experience is that quite often operational risk translates itself into credit risk and in practice it is difficult to make a distinction in between. A broader but less precise definition would increase the difficulty of better measuring and controlling operational risk.

Internal rating-based approach

Somewhat to our surprise, a large number of our banks favor the use of IRB approach. Our banks believe that this is an issue of practicality. Rather than waiting endlessly for external rating agencies to get ready, it makes more sense for banks, particularly large ones, to design their own IRB system. We, as supervisors, are not fully convinced that our banks will be able to use the IRB approach for capital purposes when the new Accord becomes effective in a few years' time. However, this is a trend

that we should encourage. Nowadays, some of our banks have started to build the IRB system and we have seen international consulting firms knocking at our doors. On one hand, we are concerned about the huge cost of the banking sector in developing the IRB system. It is worth noting that unlike in mature markets, there is almost no IRB system that can truly meet the operational requirements for capital purposes in many emerging markets. On the other hand, we are concerned that we may end up having a variety of IRB systems that are difficult, if not impossible, for supervisors to validate. We, therefore, suggest that the Basel Committee develop a prototype IBR system as an option for banks to use, particularly those in emerging markets. Of course, such a prototype IRB is just an option and needs to be adapted to suit local circumstances. Along the same line, it would be desirable if the Basel Committee could also consider providing prototype banking returns and model guidelines that supervisors can use while changing the current regulation and supervisory practice. Specific guidance to help validate the foundation IRB approach would also be helpful. Indeed, supervisors in many emerging markets encourage banks to use the US loan classification both for supervisory reporting and risk management. The development of the prototype IRB is another area where supervisors can take a supportive role. Such an effort would significantly reduce the cost of developing the IRB system in emerging markets, facilitate the wider adoption of the new Capital Accord and in so doing contribute significantly to the safety and soundness of national and international financial systems.

We hope that our comments will be helpful and look forward to a close cooperation with the Basel Committee.

Sincerely yours,

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