RESERVE
BANK
OF NEW ZEALAND

Donald T Brash
Governor

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FAXED

Mrs Danièle Nouy
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
SWITZERLAND

By mail and fax: 0041 61 280 9100

Dear Mrs Nouy

PROPOSED NEW CAPITAL ADEQUACY FRAMEWORK

We have reviewed the Committee's January 2001 proposals for a new capital adequacy framework for banks and reflected on what they might mean in the context of the approach taken to bank supervision in New Zealand.

While we generally endorse the approaches being taken in pillar 1 and pillar 3, we continue to have concerns with aspects of pillar 2. In particular, we believe that the validation mechanism envisaged would undermine the incentive-compatible regulatory approach that we have used to promote bank soundness over recent years. This concern was highlighted in the submissions that we made on the Committee's June 1999 proposals. The release of more detail in January 2001, with clarification of what the Committee has in mind for pillar 2, has not ameliorated our concern -- if anything, it has increased our uneasiness with this aspect of Basel 2.

Much of Basel 2 has the desirable feature of providing a menu of options to accommodate bank and country-specific circumstances. We would hope that additional flexibility could be provided in pillar 2 to accommodate alternative approaches.

Our approach has given particular emphasis to:

- strengthening incentives on bank management and directors to manage their bank prudently;
- creating an environment whereby market participants have strong incentives to monitor the performance of banks.

Having the bank supervisor directly and explicitly involved in validating a bank's measurement of risk and assignment of the capital buffer, as envisaged in pillar 2, might well be a sensible strategy for those countries whose governments are clearly confronted with a contingent liability should a bank fail. For a country like New Zealand, where the contingent liability is considerably weaker, the approach could well have perverse outcomes. Our view is that explicit and direct

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An alternative, yet effective, validation mechanism for countries embracing an incentive-compatible regulatory approach would be to place this responsibility primarily with bank directors. In the case of New Zealand, this might take the following form. Each bank director would be required to attest publicly in the bank's quarterly disclosure statement as to the soundness of risk measurement and capital assignment (as is currently the case in New Zealand), but only after credible, independent, expert scrutiny and assessment of the appropriateness of relevant systems and processes, and the allocation of capital for the specific risk characteristics of the bank. A requirement could be imposed on banks to undertake these independent assessments, perhaps annually, using pillar 2 expectations as the template, with full disclosure of outcomes and process. Independent assessments could be undertaken by credible professional entities such as credit rating agencies and major accounting firms, with the choice possibly being subject to supervisory approval. Supervisory intervention to deal with inadequate systems, processes or capital buffers could be based on this independent scrutiny together with our regular off-site reviews.

In our view, such an approach would leave the primary responsibility for these matters where it should be, with the bank's directors, and transparency and market discipline would be enhanced. It does not constitute an outsourcing of the supervisory function, but is rather a different way of achieving the same end. It could, however, also have the incidental benefit of helping to economise on scarce supervisory resources. We recommend that the Committee considers amending pillar 2 to allow for alternative approaches of this nature.

We generally support the approach outlined in the proposals for pillar 1, subject to a validation mechanism along the lines just described being permitted. We have some reservations, though, about the complexity that is being introduced in pillar 1 and wonder if this will adversely impact on the durability of the Accord and achievement of supervisory goals. For example, systemically important banks are likely to move to the advanced internal rating based credit risk methodology as soon as they can to obtain capital relief. Under this methodology, credit risk factors (probability of default, exposure at default, loss given default and maturity), as well as the impact of the full range of credit risk mitigation techniques, will largely be determined by banks in a non-standardised manner, and in a manner which could differ materially from the simpler models used by

less sophisticated banks. In this environment, comparisons between banks could become more difficult, setting minimum requirements that are "comparable" could become more of a challenge, "arbitrage" between the different methods could be a real risk, and external monitoring and disclosure would be less straightforward. The underlying dilemma is that the greater flexibility which is a welcome feature of the new Accord has as its price a sacrifice of the simplicity and ease of application of the current approach. We do wonder if things have gone too far in that direction, given the basic purpose of the Accord -- which we take to be not to devise best practice approaches to risk measurement, but rather to help ensure that the banking system holds enough capital to absorb unexpected losses.

Another aspect of pillar 1 proposals that we reflected on was whether moving to an internal rating based approach introduces into the capital buffer too much of a "just in time capital" characteristic. As credit quality deteriorates, capital requirements under the internal rating based methodologies increase. A bank's need for capital could increase quite quickly in a stress situation, with the risk being that capital markets may not be able or willing to provide capital at the time of need. We wonder if this is the right dynamic for the supervisory community to set up. Would it not be better to have a minimum capital requirements pillar that ensures capital is more stable through the economic cycle, with recognition that from a supervisory perspective it is appropriate that there is a component of capital that is 'superfluous' in normal times? Where this train of thought leads us is to encourage the Committee to take a conservative approach to risk measurement and capital assignment in the Accord, and particularly in the setting of standardised parameters.

There is one area, though, in the standardised approach in pillar 1 where we feel the Committee has taken an overly cautious approach. That is with respect to the risk weighting of residential home mortgage lending. A risk weight of 50 per cent for residential mortgages is very conservative given the low risk nature of this form of bank lending, and takes no account of such lending being secured by residential properties. Also, the Committee is proposing to risk-weight residential mortgages at 150 per cent once they become past due for more than 90 days. This again takes no account of the security backing the loan and suggests a potential for loss that bears no resemblance to the expected loss on such exposures. The danger of taking an overly conservative approach to risk weighting is that it could generate perverse behaviour on the part of banks to avoid what they perceive as an unreasonable capital charge.

We support the thrust of the pillar 3 proposals, although we do acknowledge the risks of information overload, and the difficulty of meaningful disclosures in some areas. As with any regulatory intervention, the costs and benefits of individual disclosure requirements need to be assessed as carefully as possible, and not all may be found to jump the hurdle. From New Zealand's experience with

disclosure, we have one suggestion to make. The information to be disclosed under Basel 2 is very extensive and becomes increasingly so as banks move towards the more advanced methodologies for determining the capital charge. While professional users should have access to the detailed information proposed, for non-professional users detail can hide the key messages as to a bank's health. An approach of succinct, well-targeted, disclosure of bank corporate, financial and risk information can provide greater accessibility and more transparency for this group of users, with more effective market discipline resulting. In New Zealand, our bank disclosure statements take two forms: a brief Key Information Summary for non-professional users and a comprehensive, detailed, General Disclosure Statement for professionals, and we commend this approach.

We sent a letter to all New Zealand banks in January following the release of the Committee's second consultative paper drawing their attention to the proposals and inviting comment by the end of April. We also invited some banks to participate in the Committee's Quantitative Impact Study. As at 22 May, four of our major banks (three owned in Australia and one owned in the United Kingdom) have all indicated that their comment and participation will mainly take the form of any submission that their parent bank makes. One bank stated that they "do not support direct supervisor validation of banks' risk management systems and capital allocation in New Zealand". Another major bank indicated that they support our recommended validation mechanism. And one major bank indicated that it is likely to participate directly in the Quantitative Impact Study. Should more information be provided to us by New Zealand banks within your deadlines for feedback on Basel 2 and the Quantitative Impact Study, we will pass that to you.

I hope you find these comments useful. If you would like further elaboration on any of the points made, please do not hesitate to contact us.

Yours sincerely

Don Brash
Governor