New Basel Capital Accord

South African Banks’ response to BIS

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1 Introduction

The Board of Directors of the Banking Council resolved that the South African banking industry would issue a combined response to the new Basel Capital Accord proposals.

The responses contained in this document are primarily general rather than specific issues relating to the Accord. The references in the specific comments relate primarily to the 'Consultative Document – the New Basel Accord' and not to any of the supplementary documents.

2 The first pillar: minimum capital requirements

2.1 Credit Risk

2.1.1 Banks' responses to specific issues addressed in 'The first pillar: minimum capital requirement – credit risk':

- **Para 24-26 Interbank**

Interbank and foreign lending exposures are currently weighted at 20%. Under the Accord there are two options that the national supervisors can elect that will be applicable to all banks in their jurisdiction.

Based on international ratings:

- *Option One: One category less favourable than the South African sovereign rating of BBB- will result in a risk weighting of 100%.*
- *Option Two: The larger banks will have a rating of 100% based on Standard & Poors BB+.*

The impact of this increased weighting must be considered from two perspectives:

- *Local interbank market – the local Regulator would have to ensure that risk weightings did not change or if they did, the impact thereof; and*
- *International banks (including offshore subsidiaries) depositing with South African banks. They will have a higher capital requirement that may impact on the cost of deposits.*

The short-term concession is only available under option 2. It is not clear why this concession should not also apply under option 1.

Based on national ratings

If the supervisor chooses Option 1 i.e. 100% due to a lack of rating by the smaller banks then it could be detrimental to the larger banks that may be able to utilise local ratings and apply a lower weighting. This will lead to differences between regulators, as local regulators will allow a lower risk rating as opposed to international regulators who may not accept local ratings.

- **Differentiation between domestic and international ratings**

Credit ratings should differentiate between domestic and international ratings and the risk weightings set accordingly for domestic and cross-border exposures.

Borrowing entities within a country should carry domestic ratings. Bank exposures to domestic entities must be weighted according to the domestic rating without reference to the sovereign rating.

External ratings and the corresponding risk weightings should only be used to determine the capital requirements for those banks that lend cross-border into other political and currency regimes on such assets held.

- **Para 33 Un-rated versus B-**

The fact that un-rated counterparties will carry a weighting of 100% but those that are rated B- and below will be weighted at 150% must also be questioned. This anomaly will be more prevalent in an emerging market where very few corporates will have an external credit assessment institution (ECAI) credit rating and may hinder the development of the external rating mechanism.

In an emerging market environment the corporates that are rated are generally below B-, and will carry a 150% weighting, and yet they are the larger more credit worthy clients.

These more credit worthy clients generally utilise the sounder, larger banks. With the inclusion of a 150% weighting for those counterparties rated below a B- it will lead to greater capital having to be maintained by these larger banks which will increase the cost to the more credit worthy clients.

- **Para 33 Granularity**

The weightings categories for the ratings are not granular enough for the South African market and the categories are too big under the standard approach. It would be beneficial to include greater granularity e.g. BB+, BB and BB- instead of just BB+ to BB-.

- **Para 53 External credit assessment institution recognition**

It is unclear whether local affiliates or franchises of international rating agencies will get automatic recognition from local regulators.

- **Para 76 Eligible collateral**

The permissible collateral under the standard approach is too narrow and should include physical collateral such as aircraft and financial collateral such as guarantees and insurance contracts.

- **Para 140 'w' in credit derivatives and guarantees**

The 'w' factor in the risk weighting of a credit derivative or guarantee is the remaining risk. Having both an explicit residual risk charge and an operational risk charge constitutes double counting.

2.1.2 Banks' general comments on 'The first pillar: minimum capital requirements – credit risk'

- *Lack of Incentive to move to IRB (Internal Ratings Based) approach*

Initial indications are that the proposed formula does not give enough incentive for the larger banks to want to move to this approach in many areas.

Under the Standard method for corporates, a 100% weighting is associated with a rating of BBB+ to BB-. Anything below BB- gets a weighting of 150%. In the case of the IRB method, a 100% risk weighting is associated with a probability of default (PD) of 0.7%. According to the Standard and Poors table, a PD of 0.7% is associated with BB+ territory. Therefore, the cut-off point of a 100% weighting appears to be more stringent under the IRB approach.

In the case of most large banks, the corporate exposure book is probably skewed towards the BB/B credits. In this case, it would be more beneficial for the bank to follow the standard method. A rating of BB- has a PD of around 2.5%. This will result in a benchmark risk weighting (BRW) of around 200% under the IRB method.

Banks will gain the benefit of moving to the IRB method with a bias of BB+ and above. These banks will be able to benefit from the infinite granularity of the BRW process. For example, if a bank has an exposure better than A- but worse than AA-, it can pick up a BRW of less than 50% but more than 20% whereas the standard approach just has the discrete steps.

- *Emerging Markets*

Local banks that are not active in the international market but operate in an emerging market dominated economy would by implication be prejudiced as the reduction in their credit risk component would not offset the increased requirement for operational risk.

- *Competitive Equality*

The new Accord allows for more flexibility within individual environments, based on risk management capability and internal control assessments. The downside to this is that, although the Accord aims at 'competitive equality', the bigger, more advanced banks may have access to options that will give them a market advantage, whereas the smaller banks may find it difficult to afford the necessary infrastructure investments.

- *Ratings*

  - Sovereign

    The South African Government rating will be 100% unless the national supervisory authorities use their discretion to lower the rating. This will require South African banks to hold capital against the liquid asset portion that relates to Government stock.

  - International Ratings versus Local Ratings

    The effect of whether the supervisor applies local or international ratings to banks and corporates will be significant. If international ratings are used then the weightings will be 100% in almost all cases.

    If local ratings are going to be used, it will have to be ensured that **all** Regulators use the same ratings. Opportunities for arbitrage may result if this is not done.

  - Corporates

    The majority of South African corporates do not have ratings and in most cases will be limited by the sovereign rating of BBB- and therefore will carry a weighting of 100%.

  - Economic Impact

    The inability to access funds by the lower rated companies, if the IRB approach is taken, could have significant impact on South Africa's economy.

- *Data Collection*

The Accord requires historical default and recovery data covering an observation period of five years. However, the transitional phase will require a minimum of two years of historical data for implementation. Resources will have to be allocated to this area to appropriately satisfy the requirements for data to support credit modelling. As a result banks have to start allocating additional resources prior to obtaining any of the benefits in the form of a reduction in capital being realised.

- *Portfolio Modelling*

The Accord maintains the distinction between the banking and trading books. This distinction is becoming blurred by developments such as portfolio management, and the increasingly artificial banking/trading split is under threat for regulators going forward.

The current proposals do not extend as far as permitting portfolio modelling. True portfolio modelling recognises default correlations in the calculation of portfolio-level capital or unexpected loss.

- *Frequency of review*

The documents do not stipulate how often the banks should update external ratings. In this respect, the fixed risk weights specified in the 1988 Accord (0 %, 20 %, 50 % or 100 %) are easy to apply since a specific counterparty is assigned a risk weight once and for all, while the proposed system might imply that the risk weight is later changed.

We suggest that updates in external ratings should be done on an annual basis or as soon as the bank is informed of a rating change.

- *Banks and Sovereigns*

  - Foreign Bank Loans

    Foreign banks, which have previously been able to weight loans to South African banks at 20%, will have to weight at 100%. This will affect both the pricing and volume of loans.

    The option selected by various regulators (i.e. sovereign related or bank specific) may also result in banks lending to offshore subsidiaries of South African banks having to hold different capital amounts.

  - International Banks

    Large international banks operating in South Africa will be able to reduce capital requirements based on their international client base that may allow these banks to have a competitive advantage.

    Foreign banks may be able to cross-subsidise pricing in the South African market which may lead to domestic banks losing their better clients resulting in a decreasing quality and increasing risk profile for these banks.

    The new rules may also result in the large international banks freeing up some of their current regulatory capital. In cases where lending is currently constrained by regulatory capital, these banks will have the scope to increase their business across the entire lending spectrum.

- *Data for the IRB Approach*

There is a lack of historical data availability in the South African market on Probability of Default and Loss Given Default. Consequently flexibility should be permitted allowing mapping to external data, statistical models etc. Where South African banks have operations in Africa it is going to be difficult to obtain meaningful PD data due to a lack of industry database and company ratings in these countries.

- *Adoption of IRB approach across all exposures*

The Accord requires that the IRB approach must be applied across all exposure classes and significant business units within a short period of time. An aggressive and articulated plan to adopt the IRB approach across all significant business units has to be agreed with the home supervisor. The costs and resources to do this will only be applicable to the larger and international banks operating in South Africa. This requirement may also inhibit the adoption of the IRB approach in the corporate and retail areas due to the lack of ability to adopt the IRB approach in certain areas (e.g. African operations).

- *Unutilised weighting*

There appears to be no logic behind commitments requiring to be weighted at 75% regardless of maturity under the IRB method, compared to the Standard Approach. The Standard Approach differentiates between less than one year (20%) and over one year (50%). Weightings should not penalise the IRB approach.

- *Risk Mitigation*

  - Eligible collateral

    It is unclear as to why gold is recognised as the only acceptable commodity. Consideration should be given to expanding the definition to include other freely tradable commodities.

  - Credit Derivatives

    Capital relief is given with respect to credit derivatives and guarantees where the external assessment of the counterparty is A or better. As potentially few counterparties in South Africa have this rating it is likely to detract from the development of this market unless national ratings are used.

  - Maturity Mismatches

    The Basel Accord allows netting of counterparty exposures across maturity dates whereas the South African Reserve Bank does not permit this. This puts South African banks at a disadvantage to foreign banks lending into the South African market.

2.2 Asset securitisation

2.2.1 Banks' responses to specific issues addressed in 'The first pillar: minimum capital requirements – asset securitisation'.

- ***Para 520 and Para 532 Third party credit enhancement***

Due to the fact that external credit enhancement is not generally available and the cost and terms are likely to prevent its use, banks that wish to securitise will have little choice but to provide their own credit enhancement:

- *Credit enhancement provided by an originating bank will be regarded as a capital impairment. Where for example 20% of a securitisation is secured by the originating bank this leads to the following anomaly where an 8% coefficient is assumed (per R100 of assets):*

  - *At 8% capital required before securitisation - R8;*
  - *At 8% capital required after securitisation - R20.*

  This will lead to the situation where 2.5 times more capital is required for what is essentially the same risk.

- *It is therefore recommended that some form of discretion be granted to banks where external credit enhancement is not a feature of such market (this could for example be evidenced by lack of competition in the market or rates and/or terms offered being significantly out of line with industry norms for such assets in the banking sector).*
- *In the circumstances envisaged above it is recommended that the regulatory authority be permitted to phase in the impairment over a 5 year period (i.e. in the example above capital of R4 will be required in year 1, R8 in year 2 and so forth). This discretion will provide sufficient time for an external credit market to develop in line with international norms.*

2.2.2 Banks' responses on general issues in 'The first pillar: minimum capital requirements – asset securitisation'.

The current level of securitisation by banks in South Africa is minimal and consequently the impact of the Accord will only be in the future.

Certain structural weaknesses still exist in the South African markets, which are likely to prejudice South African banks that apply BIS rules on a best international practice basis. These structural weaknesses include:

- The limited availability of external credit enhancement.
- Mortgage insurance is not a feature of the South African markets.

- Even where external credit enhancement is available the terms and cost make its use impractical for securitisations.
- The risk / reward relationship is not well established.
- Local rating agencies have yet to gain general acceptance by financial markets.

2.3 Operational Risk

2.3.1 Banks' responses to specific issues in 'The first pillar: minimum capital requirement - operational risk.'

- ***Para 20 Capital requirements***

A number of countries have a minimum capital requirement greater than the minimum 8% requirement. It would have to be clarified whether an additional capital charge for operational risk would be included for South African banks with operations in these countries. Potentially, the Pillar 2 section can introduce wording that encourages regulators in these countries to adjust their ratios to fully compensate for the new operational risk charge. It should also be noted that the South African Registrar of Banks has just announced an increase in the minimum capital reserve requirement from 8% to 10%, effective 1 October 2001. Imposition of the additional requirement for operational risk will further disadvantage local banks in comparison to international banks or banks in other jurisdictions still operating on the Basel minimum of 8%.

- ***Para 22 Use of gross income as an indicator***

The appropriateness of using gross income as an indicator to measure operational risk is questionable as larger banks with larger gross incomes would generally adopt more rigorous operational risk management techniques and should therefore be required to incur a lesser capital charge. The proposed linear methodology may prove to be an overly crude approximation, as risk does not necessarily grow in a linear fashion. It may be necessary to consider a cap on the operational risk charge.

- ***Para 26 Breakdown of retail is insufficiently comprehensive***

The breakdown for retail operations does not appear to be sufficiently comprehensive. A single measure (average assets) across substantially different types of business is not adequate and there is a need to split into different businesses and identify different indicators.

- ***Para 33 and Annexure 4 Identification of loss types***

- *The identification of loss types should not be linked to a fixed list but should rather be process driven because the business environment differs geographically (internationally) and loss types are business specific. The process should be conducted on a country basis*.

- ***Para 45-47 The floor level of the Internal Measurement Approach***

The level of the floor to be applied in the Internal Measurement Approach should not be too high as it could result in non-migration from the Standardised Approach to the Internal Measurement Approach

- ***Para 50 Insurance***

Although it is being considered, the impact of insurance is not currently brought into account. The banks will end up paying twice (i.e. insurance and capital) and there is currently no incentive for managing the insurance aspects well. Insurance usually limits the top end of certain operational losses. Consideration may be given to putting a cap on the operational risk charge.

The treatment of insurance using a captive fund is not clear. Will the Regulator look to what has been insured outside the group?

2.3.2 Banks' responses to general issues on 'The first pillar: minimum capital requirements – operational risk'

- ***Methodology***

There is no commonly accepted methodology for operational risk. In addition it is not always possible to quantify the operational losses and there may be no data to handle exceptional events e.g. massive fraud.

- ***20% weighting***

It is not clear whether the 20% guideline is reflective of South African conditions due to a lack of loss data.

- ***Incentives***

There do not appear to be incentives built into the Standardised Approach to take account of issues such as compliance, internal audit, business continuity planning, extent of systems, new products committee, dedicated information security officer, etc. Neither the basic indicator nor the Standardised Approach are risk sensitive and they fail to recognise risk reduction/mitigation that results from risk management and control environment.

In addition there is no incentive to improve once minimum requirements have been met. Although it would probably be addressed to a certain degree under the most advanced

approach this will not be adopted for quite a while in South Africa due to a lack of a database.

- ***Risk Conversion factors***

The risk conversion factors (beta and gamma) that apply to approaches 2 and 3 are based on industry averages, which could reduce the incentive for individual banks to improve their operational controls.

- ***Loss History***

In order to move to the advanced approach banks would have to maintain a comprehensive loss database. In the South African market the following is relevant:

- it is unlikely that an individual bank would be able to individually collect the required number of observations. This would require an industry database (normally maintained by the industry association) and raises the question on whether this data can be applied uniformly to all banks especially in terms of extreme events;
- a sharing of data in an environment with a small number of incidents but of a potentially high value may not be an option as the individual bank could be identified;
- an industry database may not result in well-managed banks getting the deserved credit;
- an internationally based loss database would probably not be representative of South African circumstances; and
- there would have to be clarity on where losses would be allocated and what makes up operational losses (not just within a bank, but across an industry).

- ***Use of assurance providers***

The use of assurance providers such as internal audit and compliance as a starting point is not addressed in the document.

Consideration could be given to permitting internal models that take internal and external audit ratings into account when:

- allocating capital between business units; and
- determining the absolute level of capital to be held.

This would make the approach more risk sensitive and unique to an organisation.

3 The second pillar: supervisory review

3.1 The banks' responses to specific issues addressed in 'The second pillar – supervisory review processes.'

- ***Para 84 Economic Value Decline***

The Accord states that supervisors should be attentive to the sufficiency of capital if the economic value declines by 20% of the sum of Tier 1 and Tier 2. However the Accord does not indicate whether the 20% outlier indicator is based over one year or a lesser period. The definition of economic value is not given.

- ***Para 81 Rate Shocks***

South African banks contain predominately non-G10 currencies. Using the five-year observations the prime rate has had a 900bp move. However at current prime rates of 14,5% it is unlikely that rates will decline by 9%. It would be more appropriate to apply a relative percentage than a flat amount.

It is not clear whether the 20% outlier indicator is based on the impact over one year or a lesser period. A one-year period may be too long as 'corrective' action could be taken.

4 The third pillar: market discipline

4.1 The banks' responses to specific issues addressed in 'The third pillar – market discipline.'

- ***Para 17 Characteristics of Disclosure***
  - The Accord does not define what constitutes disclosure. Would disclosure in areas other than the Annual Financial Statements be acceptable?
  - The Accord does not clarify whether a foreign branch has to publish its market disclosure separately in the foreign market.
  - The Accord does not indicate whether the disclosures are subject to audit. If they are to be audited and reported quarterly, which is not the norm in South Africa, this will create an additional cost to the banks. In addition some of the disclosures are generated by complex internal models and may be difficult to audit.
- ***Comparability***

There will need to be some exemptions for first period disclosures including the first period when an internal risk model is introduced.

4.2 The banks' responses to general issues on 'The third pillar – market discipline.'

Excessive Information

Any disclosures should meet the principles of meaningful, measurable and manageable. However it is unclear whether the Basel Committee have identified the disclosure detail required by market participants e.g. analysts and rating agencies. Disclosure of too much detail may confuse the user as the market participants just want to know the approaches taken. The Accord, in its final version, should require levels of disclosure that are consistent with International Accounting Standards e.g. revised IAS 30.

Quarterly Disclosure

The large internationally active banks are to make quarterly disclosures, which is appropriate given their impact on the international financial markets. However, South African banks only disclose their results semi-annually, again appropriate for local market conditions. Where there are foreign branches or a subsidiary operating in South Africa the cost of local quarterly disclosure is likely to outweigh any potential benefit.

Sensitivity of Information

Certain information may be sensitive e.g. back testing on daily data including profit and loss as well as operational losses by business line. Due to the size of the South African market, the information disclosed could present opportunities for competitors to trade against.

Disclosure variation

The extent of disclosure will vary depending on whether the bank is following the Standardised or IRB approach. This could be detrimental depending on the sensitivity of the information in a small market.

Definition of past due and impaired loans

Greater clarification is required on the definition of past due/impaired loans to ensure consistency across countries.

Level playing fields

Greater disclosure by banks must be accompanied by equivalent disclosure by all other public and corporate entities to ensure level playing fields between corporates, compliance with consistent accountancy standards, and consistent corporate governance.

5 Conclusions

The Accord is a significant step forward for regulators and banks. The focus on banks' risk management practices and the long term goal of trying to use banks' credit models are to be applauded; but only time will tell whether the capital incentives in the Accord are sufficient to drive risk management improvement at an industry level.

It is important not to lose sight of the benefits afforded by the comparability and simplicity of the existing Accord. The New Accord will introduce a significant amount of complexity into an institution's capital adequacy calculations and internal risk measurement processes. With greater complexity comes greater potential for inconsistent application that does affect the aim of achieving a level playing field and provides a substantial barrier to entry.

The increased complexity will place an increased burden on institutions as they seek to comply with the New Accord, particularly those that wish to calculate minimum capital requirements under the more advanced approaches. The resources of national supervisors may act as a constraint to the effective implementation of the New Accord as there could, for example, be delays or incorrect assessment of the appropriateness of a particular capital treatment for a bank. In addition there will be a wide variance in the interpretation of the new framework until such time as international benchmarks are established.

We consider that it is essential that the Committee promote consistent and transparent application of the New Accord by either producing or facilitating the production of detailed guidance on the definitional and implementation aspects of the New Accord. An added benefit of this is that it would assist non-BIS member countries, particularly those where supervisory resources are limited, in adopting the proposals.

Although the complexity of the Accord is likely to increase compliance costs, these proposals are to be welcomed because they reward good banking practices and thereby contribute to the safety and soundness of the financial system. In general, we support the proposals.

The Banking Council South Africa

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