The World Bank
Washington, D.C. 20433
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MANUEL CONTHE
Vice President
Financial Sector

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Mr. William McDonough
Chairman
Basel Committee on Banking Supervision
Basel
Switzerland

Dear Bill:

The World Bank would like to commend the Basel Committee for the issues it has addressed in the revised proposal on the capital framework. The open consultation process initiated in 1999 has proven useful and we expect the ongoing consultation to also bring about further clarifications by the time the new Accord is finalized.

The need for the new Accord has arisen due to the changes in banking activities, risk management practices and supervisory approaches that have come about since the 1988 Accord. We believe that the implementation of the new proposal will contribute to disseminating best practices, improving banks' risk management systems and enhancing bank supervisory practices. This outcome is crucial for developing countries, who will greatly benefit from the adoption of the Basel Committee's standards, provided that the final Accord takes account of their specific context and needs.

The World Bank is truly supportive of the three-pillar approach and of a multi-option system that seeks to rely more closely on banks' internal systems. The Accord should provide options which would be simpler for countries to incorporate into their supervisory practices according to their level of development. We are concerned that the complexity of the proposal, especially the recommendations embedded in Pillar I, will make it very difficult for developing countries to adopt it.

If the final Accord were to solely target banks considered "significant", we fear that banks and supervisors from the developing world may consider the overall framework not applicable. Hence developing countries will be deprived of the expected benefits of the implementation of Pillar II and Pillar III. Should this happen, the recent trend towards the adoption of international standards in the crucial area of banking could be jeopardized.

In view of the Basel Committee's role as an international rule setter, the World Bank considers that it is crucial to broaden the scope of application of the Accord so that it encompasses all banks.

Sincerely yours,

Manuel Conthe

Enc.

bcc: Margery Waxman, Alain Laurin, Gabriella Ferencz (BFR);
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Comments on the Basel Committee's New Capital Framework

Executive Summary

In June 1999 the Basel Committee on Banking Supervision (BCBS) issued a proposal aimed at upgrading the 1988 Basel Accord on capital requirements. The World Bank provided written comments during the first round of consultations and also provided various inputs on an ongoing basis through the Basel Core Principle Liaison Group.

The World Bank would like to commend the BCBS for the openness of a consultation process that has led to major improvements and refinements of the previous proposals, including a more comprehensive standardized approach. We agree with the decision not to include the Basel Core Principles and the Special Data Dissemination Standard (IMF-SDDS) in the new Accord, as well as, with the decision to offer a simplified option for the Internal Risk Based Approach (IRB).

The World Bank supports upgrading the current framework on capital that is not in keeping with the risk management techniques used by the most sophisticated banks. Given the Basel Committee's role in setting international standards on banking related issues - the international community is likely to expect all banks to adopt and implement the Basel Committee's recommendations -, the revision of the Basel Accord also represents an opportunity for taking into consideration the needs of all banks regardless of their status. The new framework can help improve banks' risk management systems as well as banking supervision in developing and emerging economies, which is a very positive and necessary step.

Although the weighting system of the 1988 Accord sought to capture the riskiness of banking operations, it was too crude for the most sophisticated banks and, to some extent, unsuited to the context of non G-10 countries. The adoption by non G-10 countries of rules crafted for banks operating in stable environments, without necessary adjustments, led to unsatisfactory capital regulatory frameworks in some instances.

The World Bank fully endorses a framework that seeks to align capital requirements more closely with risk. By providing a continuum of options, the new framework will be more in keeping with the level of sophistication of a bank's risk management system, which is a constructive development. Provided that the calibration of incentives is adequate, the banks will have interest in enhancing their risk management systems prior to being allowed to move along the continuum of options.

The World Bank also supports the new three-pillar approach, that is a combination of quantitative (Pillar I) and qualitative elements (Pillar II and Pillar III). The adoption of the three-pillar approach will translate into better risk management and more appropriate capital levels. The BCBS proposal should contribute to the dissemination of best practices in non G-10 countries, provided that the final document better reflects the needs of less sophisticated banks. All in all, the World Bank' view is that the complexity of the framework (particularly Pillar I) may deter developing countries from adopting it, even though they would benefit particularly from the implementation of Pillar II and Pillar III.

A bank's ability to cope with adverse trends and weather crisis episodes is enhanced when its regulatory capital coincide with its economic capital, i.e. when regulatory capital is set at

a level which is commensurate with actual risk exposures. Although the minimum capital requirement has not been amended - it is still set at 8% -, the BCBS is right in urging banks and their supervisors to focus on economic capital regardless of the regulatory requirement, which will involve a major shift for most developing countries where quantitative rules have too often been the focal point.

Detailed Comments

1. Scope of application

The World Bank's view is that many of the recommendations embedded in the current proposal are worthy of consideration irrespective of the environment where banks do business.

- The question of direct interest to the World Bank is whether the new framework is appropriate for banks operating in developing and emerging economies. While it is widely recognized that the BCBS's proposal is rigorous and meaningful in view of the recent developments in the banking industry, it is also underscored that its complexity is somehow disproportionate for less sophisticated organizations.

- In view of the Basel Committee's leading role as an international rule setter, it is reasonable to expect that non G-10 countries will seek to implement the new Accord as they did for the 1988 Accord. Nevertheless, the challenge will be more difficult this time as the current proposal represents a substantial leap in sophistication, which mirrors the development of new techniques for risk management, monitoring and mitigation in leading banking organizations. Compared to the previous Accord, the sophistication of the proposal may result in non G-10 countries being reluctant to adopt the new proposal, even though it targets now the broader community of "significant banks" in lieu of that of "internationally active banks" that was originally envisaged. In the absence of a straightforward recommendation that the new framework applies to all banks, the World Bank is concerned that non G-10 countries might lack the proper incentives to adopt and implement it, which would be an unwelcome outcome.

- With regard to Pillar I, most developing countries would be expected to implement the basic elements of the new standardized approach as the use of external ratings is very limited in most developing and emerging economies and also given the fact that the Internal Risk Based Approach (IRB) is unlikely to be adopted in the foreseeable future. Nonetheless substantial progress could be achieved with respect to risk management and banking supervision, if the recommendations dealt with in Pillar II and Pillar III were adopted, implemented and eventually enforced. In sum, the benefits that are likely to derive from the implementation of Pillar II and Pillar III should encourage a simplification of Pillar I with a view to facilitating the adoption of the new Accord by non G-10 countries.

2. Pillar I

The complexity of the simplest option (standardized approach), in addition to its reliance on external ratings, means that not many developing countries will be able to implement it. Thus, the Basel Committee may envisage extracting the simplest elements of Pillar I with a view to explicitly targeting less complex banks.

- Pillar I has been improved compared to the initial proposal. Especially relevant are the more simplified option for the IRB (foundation approach), the possibility of using export agencies' ratings, and the decision to abandon the sovereign "floor".

- With respect to the reliance on external ratings, which represents a major building block of the standardized approach, the World Bank agrees with the Basel Committee that, while an imperfect solution, it is an improvement relative to the current "Club Approach". Nonetheless, as mentioned during the first round of consultation, the World Bank is concerned that market participants may overreact to external ratings downgrades as they did in the past. The development of the IRB will contribute to mitigate this risk provided that banks develop their own system, i.e. do not excessively rely on external sources for measuring and slotting their own risks.

- Given the increasing number of external rating agencies, most of them domestic, it is extremely important that supervisors put in place a close monitoring process of the quality of the rating process in keeping with the Basel Committee's recommendations. If the quality of the rating process were not up to the Basel Committee's minimum criteria, the objective of aligning capital charges to risk will not be achieved.

- The possibility being offered of relying on the Export Credit Rating assessments is welcome, as it will result, *inter alia*, in a larger geographical coverage of country risks.

- Given the importance of claims on government entities and public sector entities in the portfolios of banks in developing economies, the World Bank suggests that more guidance be given to supervisors on the conditions for these entities to be eligible for the lowest weight.

- The low weight for inter-bank lending strongly encourages countries to obtain an international credit rating. However, we have seen during the Asian crisis in 1997-1998 that, when a country goes through an economic crisis and is downgraded to B- and below, its access to foreign exchange in the form of trade lines is severely limited. Under the new system, the risk weighting could jump from 20% to 50% or even 150%. This will have a major impact on trade finance activities of lending banks. For example, a confirmed letter of credit to rated banks in rated sovereigns undergoing a crisis would require steeply increased capital requirements (possibly higher than those applicable for un-rated countries), which would have a direct impact on cost and access to trade finance. This low risk activity, which is vital to developing countries, would be disrupted, thereby causing further damage to economies facing severe distress.

3. Risk mitigation techniques

The new Accord recognizes the innovations that have taken place in the area of credit risk transference and provides guidelines on how these new instruments could be utilized and approached.

- The new Accord recognizes the innovations that have taken place in the area of credit risk transference and provides guidelines on how these new instruments could be utilized and approached. Moreover, partial risk mitigation is also rewarded. This allows for a number of transactions and/or issuers in client countries that would otherwise have difficulties in accessing external capital to take advantage of such instruments (especially those of Multilateral Development Banks) and leverage them in financial markets.

- It is unclear the extent to which the mitigation facilities, such as sovereign guarantees provided by Multilateral Banks, - including the World Bank - will be accounted for in calculating the capital requirement of a bank involved in this type of transactions. This issue is crucial since most Multilateral Banks are developing some forms of guarantee programs (essentially taking away the sovereign risk element). It is important to ascertain under which conditions the transaction takes on the obligor's creditworthiness, or a combination of the guarantor's and obligor's creditworthiness.

- The treatment of political risk guarantees is somewhat unclear. Political risk guarantees are insurance products that remove the sovereign risk aspect from a transaction, and leaves the commercial risk intact. Clarity on this aspect will lead to higher utilization of insurance products available in the private and public market place. Some clarification would be useful as to who will evaluate the enforceability of the document and on the basis of which criteria.

4. Operational risk and concentration risk

Operational risk and concentration risk represent very acute issues in developing countries, where infrastructures are often weak, and where there is a lack of diversification in the economy.

- The 1988 Accord supposedly provided some cushion for both credit risk (specifically measured) and other risks in G-10 countries. However developing countries did not adjust their capital requirements to reflect the higher level of risks other than credit risk.

- The BCBS proposal provides useful guidance, albeit complex, on how these risks should be addressed. Of great importance is the proposal to set a capital charge for operational risk, which represents, based on preliminary estimates, 20-25 percent of the minimum regulatory capital charge. While such a charge is likely to translate into higher capital requirements for developing countries, other things being equal, it is not sure that the current proposed calibration fits the developing countries' circumstances. The World Bank is of the view that a specific capital charge is to be

determined at a level based on the results of the quantitative impact study being conducted in a sample of banks from both G-10 and non G-10 countries.

- Likewise a specific capital charge where loan concentration represents an above average risk for banks is justified. This charge is all the more necessary in countries where rules on loan concentration are not in keeping with international best practices.

5. Capital requirement

In designing the new framework, the BCBS indicates that it does not seek to increase capital requirements system-wide. Nonetheless, this objective is compatible with individual banks being required to set aside more capital than at the present time, which should apply to banks in developing and emerging economies.

- The objective of maintaining system-wide capital in the new Accord at current level can be achieved with the unbundling of risks (credit risk, interest rate risk, operational risk), which makes it easier to fine tune capital charges. This Basel Committee's objective is likely to be achieved by off- setting the reduction in capital for credit risks – for example as a result of a more favorable weighting system for debtors having high ratings-, with new capital charges to reflect operational risk and granularity, i.e. concentration of risks. In developing countries, pending an accurate estimate of unbundled risks, it will be crucial to provide interim guidance on the calibration of a capital charge that should reflect the importance of operational risk. While the proposal clearly spells that 8% is a minimum (this was also laid out in the 1988 Accord), ample experience shows that banks as well as bank regulators are inclined to accept it as a suitable level, regardless of circumstances.

- The Basel Committee is correct in asserting that 8 percent is merely a reference, to be adjusted depending on the environment in which a bank operates and its own risk appetite. The World Bank recommends that banks operating in fragile and unstable macroeconomic conditions be required to hold capital in excess of what is considered the minimum in advanced markets. This capital charge, which accounts for macroeconomic conditions, should be complemented with an additional capital charge aimed at reflecting the risk profile of banks, including qualitative factors such as internal controls, management, risk appetite, etc. The protection of depositors and of public resources makes it an absolute necessity to impose a "buffer" commensurate with the risks involved.

6. Pillar II

It is true that the three pillars are self-reinforcing but, in an evolving regulatory environment, the World Bank views Pillar II as a crucial building block of the new Accord. The implementation of the Pillar II 's set of recommendations is likely to outweigh the improvements that Pillar I will involve for the vast majority of banks in developing economies.

- The success of the Basel's proposal in non G-10 countries will certainly be measured against whether banks and bank supervisors will be capable of adopting the four elements embodied in Pillar II.

- Irrespective of the accuracy of the measurement of risks and the techniques used to evaluate them, the adequacy of a bank's capital is a matter of business and regulatory judgment. Therefore, the determination of the required "economic capital" (i.e. the capital that a bank's management has determined necessary to reflect the bank's specific risk profile, strategies, etc. regardless of the regulatory requirement) by the banks themselves is a key element of the proposal. Similarly the supervisors are expected to acquire sufficient expertise to ascertain whether a bank's evaluation of its economic capital is adequate (supervisory review). The emphasis on the supervisory review will have far-reaching implications on the supervisors' needed skills and procedures to ensure that banks have adequate systems. While challenging, the prospect of the BCBS proposal contributing to strengthening the quality of the supervisory process is to be viewed as a constructive step forward.

- The World Bank's view is that in most developing countries supervisors do not have the ability, based on their own judgment, to set institution specific capital ratios at a higher level than the regulatory minimum. Where they have the legal tools to impose capital in excess of the regulatory threshold, regulators may be reluctant to use them for fear of confronting banks. Supervisors may also lack the tools and skills to customize capital ratios to the risk profile of banks. The easy and non confrontational way of dealing with capital rules has been to set a single standard for supervisors to apply across the board, which the 8% guideline allowed for.

- Notwithstanding the technical hurdles to tailoring capital ratios, the banks may perceive the new system to be too loose and entrusting supervisors with arbitrary powers. Banks may also argue that this system will induce the risk of distorting the level playing field.

- The move toward a more risk- based approach in the banking industry is a necessity. This implies that supervisors will have to upgrade their own instruments. This may prove very challenging for many supervisors because supervision will become more judgmental as opposed to being ruled based. The challenges that lie ahead should be viewed as an opportunity and not as a reason for discarding the new framework.

- The World Bank is supportive of the recommendation that adequate and timely actions must be taken by supervisors towards banks no longer complying with the capital requirements. While the range of possible supervisory actions is to be adjusted to the circumstances faced by banks, it is reasonable for supervisors to require additional capital as an interim measure, until banks have taken the necessary remedial actions.

7. Loan classification and provisioning

The BCBS framework on capital does not address the classification and provisioning of impaired assets, even though this has far-reaching implications for the value of a bank's capital.

- As far as developing and emerging economies countries are concerned, the absence of a sufficiently detailed set of international guidelines on loan classification and provisioning restricts the relevance of capital adequacy framework, especially for the comparability of systems across countries. More worrisome is the fact that ill-designed frameworks have contributed to hiding banks' insolvencies as demonstrated during the Asian crisis and elsewhere. The widespread adoption of the IRB approach is unlikely to occur in the years to come in the vast majority of countries, and therefore the adoption of an international standard for loan classification and provisioning would be welcome. The World Bank is aware that these issues are being discussed by the BCBS and IASC and it hopes that the outcomes will provide specific, detailed guidelines which current international standards lack.

- We note that, under the IRB approach, the total regulatory capital includes at least a portion of a bank's general loss reserve and that IRB weights have been calibrated with the objective of achieving adequate coverage of both unexpected losses (to be covered by capital) and expected losses (to be covered by specific provisions). For banks capable of relying on the IRB approach, it is unclear whether banks will be permitted not to establish specific provisions on the ground that capital requirements capture already part of expected losses. The World Bank would like to obtain some clarification on this sensitive issue in view of its potential to impact the level playing field, let alone the fact that the comparability of IRB-banks' capital ratios versus other banks might be impaired.

8. Credit risk mitigation and real estate collateral

The document provides comprehensive and meaningful recommendation that should facilitate the development of credit risk mitigation tools practices in emerging economies.

- The distinction made about risk-weighting between commercial and residential real estate is justified by the observed greater volatility and lower quality of commercial real estate.

- The document is somewhat ambiguous about the accepted definition of real estate collateral pledge, and as a result may introduce some inconsistent or fragmented definitions.

- The standardized approach should allow banks to differentiate capital charges based on the quality of borrowers (residential) provided that clear regulatory appraisal rules, independent appraisers, prudential and documented methodologies exploiting transparent and reliable database of transaction prices do exist and are integrated into the risk management process. This possibility would make it easier for banks to move towards the adoption of the IRB approach later on.

- Given global trends in financial markets, it is important to capture operations such as specialized secondary mortgage facilities designed to purchase loans and issue various types of securities. Consistent capital and oversight rules about credit risks, operation risks and market risks are needed to avoid regulatory arbitrage.

9. Securitization and mortgage securities

The proposed framework looks very sound, clear and detailed. It is expected to represent a major breakthrough for a healthier development of MBS/ABS markets. It should help to avoid the proliferation of synthetic/hybrid schemes and fragmented illiquid markets, which do not really reallocate any credit and market risks to external parties.

- Progress has been made regarding: (i) the treatment of "reputational" risk, (ii) the fundamental and innovative distinction made between second and first loss protection (only the latter being deducted from capital by originating or sponsor banks), (iii) the regulatory treatment of different credit enhancement forms (spread account, liquidity facilities provided by the originator) although partial recourse and over-collateralization should also be treated.

- The fact that "originators" and servicers that provide credit enhancement must deduct the full amount of the enhancement from capital, taking into account the risk-based capital charge that would have been assessed if the assets were held on the balance-sheet" will encourage external allocation of credit risk.

- The proposed 20% risk-weighting treatment for investing banks of MBS rated at least above AA- should play a positive impact on the emergence of private MBS, versus the monopoly reserved to Government-sponsored facilities. It remains unclear whether the same treatment is extended to senior debt retained by issuers.

- A positive consequence for the secure development of fixed-income securities is that only AA- and above rated senior MBS should be issued and traded, as there is otherwise no expected capital relief. It may be necessary to allow domestic supervisors to have un-rated subordinated securities risk-weighted at a higher level than the proposed 150% (in the U.S., a junior MBS rated less than BB- is 200% risk-weighted).

- The case of un-rated mortgage bonds raises the sensitive issue of whether these bonds are bank claims, corporate securities, or mortgages/MBS. A mortgage bond is a banking claim, which benefits from an additional layer of guarantee through a matching pool of eligible mortgage loans (with a privilege over bankruptcy if the bank stops servicing its bond). In most European countries, it is risk-weighted at 10% or 20% even if not rated, as the security is built by law to be low-risk.

10. Pillar III

The World Bank supports initiatives aimed at enhancing transparency, which will lead to a more open and integrated world economy and easier access to finance for developing countries. The disclosure by banks of more accurate and timely information to the public is a positive step.

- It is widely recognized that transparency can have a positive impact on the banks' soundness by enhancing market discipline, even though it is not a panacea, especially where the reliance on financial markets is limited. The objective of leveling the

playing field under a multi-option framework requires providing the markets with additional information on banks' methods for estimating their own capital needs. The World Bank fully supports the objective of tightening disclosure requirements in view of the increased reliance on banks' internal management tools and models and the distinction being made between core and supplementary disclosure. The upgrading by the IASC of its standard on disclosure should also contribute to enhancing banks' disclosure policies and to achieving more consistent practices across countries as many supervisors may not be in a position to issue guidance on accounting and disclosure issues.

- The disclosure of information is a powerful instrument towards achieving more discipline provided that the information being disclosed is reliable and meaningful. If these two conditions are not met, disclosure is likely to be ineffective as well as disruptive. For transparency to operate effectively, there is a need for supervisors and external auditors to verify that the market at large is provided with accurate information. Supervisors are not always equipped to closely monitor the reliability of a bank's disclosure, and the responsibility for accuracy lies with both banks' management and external auditors. The World Bank believes that there is room for improvement with respect to the external auditors' contribution to enhancing the quality of banks' public information. The World Bank will provide comments on the Basel Committee's draft paper dealing with the relationship between banking supervisors and banks' external auditors.

- As banks' internal procedures will be tested by supervisors as part of the supervisory review, which is a key element of Pillar II, the Basel Committee should consider providing guidance as to the information supervisors should publicly disclose, e.g. supervisors' procedures for assessing a bank's capital assessment and rules and procedures applied for customizing capital ratios.

11. Possible implications of the Accord

A multi-options framework, which relies on banks' own risk management systems, automatically increases the risk of not achieving a consistent implementation of the new system across a wide variety of banks and countries.

- Even G-10 supervisors may find it difficult to verify the accuracy of a bank's internal rating systems, let alone most supervisors in developing and emerging economies. As the determination of the adequate level of capital is expected to include some form of banks' judgment subject to supervisors' review, the risk of distortions is even increased. Notwithstanding these potential drawbacks, the World Bank believes that the flaws of the one-size-fits all current framework needs to be overhauled to meet not only the needs of the most sophisticated banks but also those of less developed economies. The customizing of rules prescribed by the BCBS, while entailing risks, offers opportunities as banks and supervisors will have to improve their way of doing business.

- The potential harm of a risk sensitive framework, which might trigger more volatility within the banking industry and also adverse consequences on international capital flows, should not be underestimated. Given this potential risk, the World Bank

considers that adequately capitalized banks and meaningful provisioning policies are the best cushion against bank distress.

- While recognizing that a more risk sensitive system for calculating capital requirements, by and in itself, leads to potential volatility, the World Bank considers that this risk could be mitigated if banks were allowed to adopt a more forward-looking provisioning system. We hope that the Basel task force on accounting will contemplate the adoption of a system that will encourage banks to establish provisions during the upside of the economic cycle to be able to weather economic downturns. The World Bank is aware that a forward looking provisioning system raises several issues, including the tax deductibility for such provisions and its consistency with current accounting principles. Nonetheless, the World Bank's opinion is that the strengthening of banking systems and eventually the reduction of financial instability requires amending current standards and practices in view of the specific nature of banking activities.

12. Other comments

The World Bank will continue to support Basel initiatives by promoting the dissemination of the BCBS framework on capital and through its long term development work in the financial sector together with the IMF in their work on financial sector stability.

- The Financial Sector Assessment Program (FSAP) will give the World Bank the opportunity to have a better understanding of how banks and supervisors will react to the adoption of the new Accord. This experience will be shared with the members of the Basel Core Principle Liaison Group. In respect of the daunting challenge that supervisors will face to keep up with the changes banks are likely to undertake, the World Bank expects its client countries to elicit its assistance in the years to come. In respect of its unique perspective in dealing with developing countries the World Bank will provide technical assistance along with other international organizations, e.g. the IMF, the Financial Stability Institute and other international groupings.