BANKING
REGULATION AND SUPERVISION
AGENCY
OF TURKEY

COMMENTS
ON
3rd CONSULTATIVE PAPER (CP-3)

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COMMENTS ON 3rd CONSULTATIVE PAPER

IMPLEMENTATION

1. Determining Significant Banks

It is known that some countries divide their respective banking system into two categories regarding the implementation of the New Accord. Banks in the first category are called "significant banks" and will be required to apply the provisions of the New Accord while the banks in the second category can remain in the framework of existing Accord. This type of splitting may be a viable alternative implementation policy for some non-G10 countries.

However, this issue will still be a challenge for supervisors. Therefore harmonizing the eligibility criteria to determine the significant banks and also determination of stricter regulations applied to banks other than significant ones considered as issues that need careful attention.

2. Cooperation with Accord Implementation Group

While the New Accord is prepared for internationally active banks of developed countries, like the 1988 Accord, other countries will also implement the New Accord. The wide range of participation for QIS-3 can be regarded as an indicator of a wider implementation.

Therefore the cooperation of Accord Implementation Group with national supervisors of emerging countries is an important issue. Participation of these supervisors into the Group and establishment of a sub-group that works on the implementation of the Accord in emerging markets will definitely ease the problems faced in implementing the Accord.

REGULATORY CAPITAL

3. Capital Requirements

Despite the New Accord imposes more risk-based capital requirements for banks; we believe that it is also very important to apply a similar framework for non-bank financial firms. We appreciate the Basel Committee's efforts regarding the cooperation with other institutions (IOSCO, IAIS, ISDA, etc.).

4. Procyclicality

Banks adopting an IRB approach will alter their lending behavior, as they will no longer have an incentive to hold lower quality loans. This would lead reducing the lending to the companies in the emerging markets by major international banks. The consequences of a reduction in lending to emerging countries, which are mostly in need of funds, may be severe. An additional potential impact resulting from the systemic impact of widespread adoption of

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IRB approaches, could increase procyclicality of lending to emerging markets, thus increases risk of crises and their spillover effects on a global base.

5. Diversification and Correlation

The New Accord does not adequately recognize the effects of diversification in assessing capital requirements. In other words, it is assumed that a bank's total risk is equal to the sum of market, credit and operational risks. In fact, the overall risk profile of the bank may be less due to correlations among various risk factors. We believe that, risk aggregation framework needs to be improved over time.

CREDIT RISK-STANDARDISED APPROACH

6. Cash Collateral in Simplified Standardised Approach

In Annex 9, in 169th footnote of 46th paragraph, it is mentioned that the exposure covered by collateral should be risk weighted after any necessary haircuts for currency risk.

However, regarding 39th paragraph of the Annex 9, only the simple approach for collateral can be used in simplified standardised approach and assets that have a currency mismatch with the exposure will be excluded from the eligible collateral definition.

Therefore, provisions for haircuts should be removed from 169th footnote.

7. ECAIs

We consider that one of the major concerns of the new Accord is the external ratings issue, particularly for emerging markets. The New Accord puts External Credit Assessment Institutions (ECAIs) on a prominent role despite widespread worries about the quality of assessments of independent ECAIs whose ratings are not always regarded accurate and in fact tend to follow market trends rather than anticipate them. Basel II will apparently necessitate an important interaction between the rating agencies and regulatory & supervisory authorities. The rating issue will have several implications over sovereigns and banks and we will attempt to focus on some of the most important aspects of it from an emerging country perspective.

While Basel II (and also Basel I) has initially targeted the internationally active banks in G-10 countries the current situation indicates that many of the countries implementing regardless of developing or developed ones have declared their desire to implement the new Accord. However, the main concern so far has been the impact of Basel II on major banks, not on emerging countries' banks except QIS-3, which included the non-G10, and non-EU countries' banks.

We hereby would like to contribute the essence of level playing field in terms of rating agencies' assessments by proposing certain set of rules for a more efficient and reasonable rating assessments.

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Beside all, risk assessment of banks and banking systems needs special treatment than assessment of other firms. Therefore ECAIs should be in close cooperation with banking supervisors. Also bank supervisors should establish a ground that harmonizes external rating methodologies especially for emerging markets.

Firstly, Basel II with its current structure may significantly restrict international banks making loans to emerging countries with lower credit ratings since international banks may not be willing to lend money to lower rated countries.

Secondly, Basel II in its current form will inevitably amplify the risks that banks are calculating even in the case of a slight transition from BB to B. Initially, most banks in Turkey are expected to use the standardized approach while some banks have declared their intention to adapt IRB approaches in time.

Last but not least, the transition to the more sophisticated approaches seems too challenging and the ability of regulators and banks in emerging markets in terms of sufficient and adequate resources for implementation is questionable.

More importantly, since fundamental differences exist between developing and developed countries, the tools used to assess the creditworthiness of a developed country may either be useless or produce misleading results for an emerging country. Beyond those, macroeconomic environment and microeconomic factors significantly differ between developing and developed countries that make ratings comparison less efficient. In this context, Basel II does not sufficiently consider the special situation and concerns of emerging markets. Since many companies and banks had not been rated in emerging markets, the quality of rating agencies' ratings may not reflect the actual condition of the rated institutions. Hence the role assigned to the rating agencies is very important not only for the banks but also the overall economy of emerging countries. Also from a bank perspective, ratings, from time to time, may not be a reliable interpreter of the perception of risk in the markets.

Our Proposal

Despite the benefits of using third-party ratings in addressing risk, the use of ratings by regulators to assess the creditworthiness of banks and companies may raise some issues that need special attention. There may be unintended consequences arising from regulatory use of ratings and banks and companies may seek the unique opportunity "rating shopping" often.

As cited by many sources, public availability of ratings is an important component of transparency, especially when combined with the publication of an historical record of defaults, by rating category and time horizon, and publication of transition matrices.

Some ECAI also points out to the need for supervisors to become familiar with the various rating systems used to indicate risk. For supervisors to effectively assess risks, they might need a totally different set of parameters than the commonly used foreign currency ratings, local currency ratings, financial strength ratings and national scale ratings.

Given the issues discussed so far, the BRSA has decided to initiate and conduct a quasi-quantitative impact study with a considerable number of banks as a project of Steering Committee on Basel II. This study intended to guide both BRSA and banking sector to gather

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necessary inputs for strategy setting (i.e. necessary infrastructure for Basel-II, changes in bank lending behavior, etc.). The study is expected to be completed by the end of 2003 and seek to supplement the one already conducted.

Since the accounting systems, quality of data, existence and efficiency of markets and even the supervisory framework may significantly differ from one country to another, we finally would like to propose an integrated approach, in which the use of rating agencies' assessments needs to be supplemented by a uniform and adequate set of regulatory tools to ensure to level the playing field.

To address this issue Basel Committee may initiate a process to establish clear and fair rating recognition criteria that emphasize the quality and consistency of ratings across rating agencies and to remove market imperfections to provide an equal competitive ground.

Therefore a working group that consists of banking supervisors of G-20 countries should be established for harmonization of the eligibility criteria of ECAIs and working on the role of ECAIs in the standardized approach and risk mapping. The works of this group will definitely help supervisors to define their policies for ECAIs.

To summarize, there must be a set of rules that enforce all rating agencies that introduces a uniform set of standards for them such as objectivity, independence, international access/transparency, disclosure, resources, comparability and credibility. Hence the standards to be uniformly applied by rating agencies within Basel II framework needs to be drafted without any delay.

8. Preferential Treatment for Sovereign Exposures

The discrimination of risk weights of sovereign exposures according to their denomination in domestic or foreign currencies is an open question. The new proposal states that a lower risk weight can be assigned as long as exposures to sovereigns are denominated in domestic currency. For foreign currency exposures the risk weights depend on external credit assessment by private rating agencies or export credit agencies. Regardless of the type of the currency of the exposure, it is assumed that the sovereign that defaults will default on all kinds of currencies. This approach may result in an increase in the cost of lending of internationally active banks having substantial sovereign credit portfolios especially in low rated emerging markets because of an increase in risk premiums in foreign currency exposures. For these reasons, national supervisors should be given the freedom of determining risk weights for sovereign loans in all currencies including bonds and treasury bills. These should also apply for the specific risk charge for government securities.

9. Transactions Collateralized with Sovereign Securities

In many emerging countries, government securities are one of the most important types of collateral for loans.

In the standardised approach, the risk weighting of sovereign risks are determined by using their external ratings or ratings given by Export Credit Agencies (ECA). On the other hand, in paragraph 28, there is a national discretion to lower the risk weighting for banks' exposures to their sovereign (or central bank) of incorporation denominated in domestic currency and

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funded in that currency. And in footnote 11 it is mentioned that this lower risk weighting may be extended to the risk weighting of collateral and guarantees.

Regarding the paragraph 116, where the eligible financial collateral are defined, sovereign securities can only meet the eligibility criteria if their external ratings are at least BB-.

In order to harmonize the above-mentioned two provisions and effective execution of the national discretion, the discretion should also be valid for the eligibility criteria of collateral, haircuts in the comprehensive approach, exceptions to the risk-weighting floor in the simple approach and also collateral in the simplified standardised approach.

Therefore, a footnote should be inserted regarding paragraph 116/c in which a national discretion that allows national supervisors to accept sovereign securities, treated within the framework of 28th paragraph, as an eligible financial collateral.

In order to implement this discretion in simplified standardised approach, a similar footnote should also be inserted regarding 46th paragraph of Annex 9.

On the other hand, accepting these securities as an eligible collateral requires the determination of respective haircuts applied to these securities in the comprehensive approach. We think that the haircuts should be determined by using the risk weights applied to these securities. For instance, if the national supervisor determine a 20% risk weight for these securities, the applicable haircut for these securities should be the same with a sovereign security that have rating A+ to A-; therefore the haircut should be 1%, 3% or 6% depending on the residual maturity. For this discretion, a footnote should be inserted regarding 122nd paragraph.

And to qualify as an exception to the risk weight floor in the simple approach, regarding 156th paragraph, a footnote should be inserted indicating that if the national supervisor decides to apply a 0% risk weight for these securities, it also has the discretion to apply this risk weight for these securities held as collateral.

10. Preferential Treatment for Short-Term Sovereign Risks

For certain situations, short-term claims on banks can be risk weighed by a lower risk weight than that assigned to a sovereign with same rating. For example, a short-term claim on a BBB+ rated bank will receive 20% risk-weight, however, a short-term claim on a BBB+ rated sovereign will receive 50% risk-weight. Therefore, the preferential treatment for short-term bank exposures under Option 2 should also be applied to short-term sovereign exposures.

11. Exposures Indexed to a Different Currency

In the Accord, there should be explicit provisions for the treatment of exposures indexed to a different currency (i.e. an exposure expressed in USD but denominated in Turkish Lira). The two important issues for indexed exposures are whether these exposures can get the preferential treatment mentioned in 28th paragraph; and whether a currency haircut (H_{fx}) will be applied to these exposures when the indexed exposure and collateral are denominated in the same currency.

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12. Corporate Claims

In the Accord, corporate claims rated below BB- are risk weighted with 150%. However the threshold for 150% risk weighting for sovereign and bank claims is B-. 150% risk weighting is also applied to past-due assets. We think that the threshold for corporate claims is very high. It will be more meaningful to widen the 100% risk-weighting bucket for corporate claims from “BBB+ to BB-” to “BBB+ to B-”.

13. Consumer Loans

It is appreciated that lending, fully secured by mortgages on residential property will now receive a 35 % risk weight in the Standardised Approach compared to a 50% risk weight under Basel I and previous proposals for Basel II. On the other hand, loans to small firms and individuals (consumers) are receiving the same risk weight of 75%. In reality, the default rates of consumer loans are not as high as loans to small firms, but not equal to lending fully collateralized with mortgages on residential property either. The risk weight of consumer loans could be adjusted somewhere between 35% and 75 %. Preferably it could be set at 50 %.

14. Definition of Collateral

The range of risk mitigants recognized by the proposal is not wide enough to capture some important mitigants in certain countries. For example, postdated cheques that are assigned to banks are not recognized as a risk mitigant. However, this is a very common practice in Turkey and such cheques are highly regarded risk mitigants, given that they are drawn due to a trade transaction. Same argument holds for promissory notes. Additionally, mortgages as collateral for corporate and retail exposure has a wide range of implementation.

Regarding national discretion, risk mitigants proposed by the new accord may be widened to encompass some local applications in different jurisdictions especially in standardised approach. At least certain initiatives and more flexibility for authorization can be left to national supervisors’ discretion.

15. Eligible Guarantors

Corporate guarantees are recognized only when the rating of the guarantor is at least A-. This causes a risk-weighting differentiation between claims on corporate rated below A- and the portions of claims guaranteed by corporate rated below A-. According to our view, corporate guarantees should be recognized whenever it is higher than the rating of the debtor.

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CREDIT RISK-IRB APPROACHES

16. Evaluation of Rating Systems

Since different banks may have exposures on the same corporate, internal rating scores of the corporate may not be the same in all banks. It is an important issue how National Supervisors will make various internal risk rating processes close to each other in order to provide some uniformity to different techniques and prevent a bank from using the advantage of giving a higher grade to a corporate which may have been rated lower by other banks. Regarding the IRB approach, it is thought that the issue of achieving "optimal" level of standardization in rating systems for different banks in the same country as well as in different countries is best solved by the Basel Committee with contribution from National Supervisors.

OPERATIONAL RISK

17. Operational Risk Capital Requirement

In the basic indicator and standardised approaches for operational risk, gross income is used as an indicator for capital requirements. However, there may be some years that a bank incurs loss in one or more business lines or as a whole. Therefore, provision for these situations may be included after 613th and 615th paragraphs and also in 91st footnote. This provision may be in parallel with the ones applied in QIS-3. This means no capital requirement should be calculated for business lines that incur loss in standardised approach or alternative standardised approach, and for the bank as a whole in basic indicator approach.

18. Transfer Pricing

In order to clarify the issues on transfer pricing which is actually used by banks, there should be specific information in the Accord about the effects and usage of transfer pricing between business lines in the standardised approach.

19. Business Line Definitions

Although the standardised approach may be considered more progressive compared to the basic indicator approach, it is clear that the common relationship between the operational risk in each business line and the regulatory capital charged for operational risk is an important issue. Therefore business lines should be explained clearly and in a more detailed manner to enable a worldwide accurate and objective implementation of standardised approach.

20. Beta Factors

One other aspect of the standardised approach is the use of beta factors. Beta serves as a proxy for the industry-wide relationship between the operational risk loss experience for a given business line and the aggregate level of gross income for that business line. However,

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these beta values can differ from country to country and there should be a national discretion to allow national supervisors to calculate their own beta factors.

21. Alternative Standardised Approach

The alternative standardized approach (ASA) applies a multiplication factor (beta) of 15% for the aggregated retail and commercial banking business lines and aggregates the total gross income for the remaining six business lines with a beta of 18%. In order to encourage banks to apply more sophisticated techniques, it is believed that the betas of the alternative standardized approach should not be higher than alpha (15%) of the basic indicator approach.

22. Operational Risk Mitigation

To the extent that an institution demonstrates that operational risk has been transferred through insurance, third-party service agreements or other techniques, we strongly believe that such risk transfers should be reflected in mitigation from regulatory capital charges. However, the proposal allows only to those banks, which implement advanced measurement approaches when calculating their regulatory capital. We think that this type of operational risk mitigation should be extended to cover standardised approach.

23. Operational Risk Disclosures

For the development of the concept of operational risk management and improvement in measurement techniques, similar to the disclosure requirements for credit risk, discussion of the bank's operational risk management policy should be included in the disclosure requirements.

MARKET DISCIPLINE

24. Risk-based Accounting

Disclosure is one of the most crucial issues open to debate. In fact, recent examples of accounting scandals, balance sheet improprieties and mismanagement of banks have all reconfirmed the difficulty of market discipline and significance of sound public disclosure. Therefore, it can be suggested that both accounting and regulatory standards should be harmonized in order to have one common standard and avoid banks to report results based on different sets of accounting information. In this context, we will appreciate Basel Committee's efforts on cooperation with International Accounting Standards Committee (IASC) in order to put forward risk-based accounting principles to allow more effective risk management practices.

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OTHER COMMENTS

25. Further Explanation on Operational Risk Issues

Further explanation needed on loss classification definition, the decision tree method, event and effect definitions in order to avoid difficulties in implementations.

26. Gross Income as Operational Risk Indicator

Using gross income as an indicator for operational risk capital requirements, by its nature seems to penalize profitable banks with high gross income compared to less profitable banks and also has an indirect negative effect on incentive systems of banks.

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