Comments on the New Capital Adequacy Framework
From the Central Bank of Barbados

The Central Bank of Barbados is pleased to offer its comments on the New Capital Adequacy Framework. This third consultative package is a significant improvement over the earlier draft, providing improved explanations, more definitive standards and detailed methodologies. There is evidence that the Committee sought to address some of the many concerns of the international supervisory community, while maintaining its focus on aligning capital with a bank's true risk profile.

The designing of this approach to capital measurement must have been a tremendously difficult challenge as the needs of so many diverse groups must be considered and incorporated. Barbados was delighted to note that many of our concerns were acknowledged and addressed in this new consultative package. In particular, the Bank was pleased to see the introduction of a simplified standardised approach which although not resolving some of the weaknesses of the 1988 Accord is an indication that the committee is seeking to reduce the implementation challenges of the new Accord that will be faced by small (micro) emerging states.

The Bank also noted the reduction in the risk weights to be applied to residential mortgages, the lowering of the capital charge for operational risk, the full recognition of loan loss provisions and the concessionary weights for small and medium sized enterprises. There are however, a number of issues specific to the narrow financial markets of small open jurisdictions such as ours that are still outstanding. The Bank welcomes this opportunity to offer some comments that reflect this particular perspective.

Comments Relating to the 2003 Consultative Package

Timelines and IMF/ World Bank

As noted earlier the 1988 accord has become the benchmark for assessing supervisory standards and it expected that the new accord would become the new standard. However, as the Basel committee has noted not all aspects of the accord are relevant to emerging markets. What is also not clear is the timetable against which international agencies will expect emerging markets to adopt the new accord. The committee has noted that emerging markets may need additional time, beyond 2006 to implement the accord. It would be useful if the committee could more clearly indicate those areas not applicable for the developing nations, as well as explicitly specify a much longer implementation deadline for emerging markets.

Involvement in the Process

It is evident that small (micro) open economies such as those in the region have had little input into the development of the accord. The accord as it is structured is applicable for developed nations with few considerations given to the difficulty of implementation in our type of economies. The committee has indicated its willingness to listen to the concerns of all countries and in recognition of the challenges posed by the implementation of the accord has established a working group to look at the implementation issues. It is regrettable that no one able to speak to the peculiarities of our types of economies is represented on this working group. The Bank would want to suggest the establishment of a mechanism by which the peculiar concerns of small open economies could be communicated to this working group.

Access To The International Market

The new capital accord has the potential to disrupt the flow of foreign capital to the region. Under the new accord a number of Caribbean countries will be rated below investment grade. The committee by not considering the risk mitigation effects of the diversification of the portfolio and focusing solely on the rating to determine the capital charge may create a selection bias against such countries. This has the potential to negatively impact on monetary and banking system stability of affected countries. The adoption of the existing Basel guidelines in many countries, led to the decline in sovereign bank lending to developing countries. This will now affect the willingness of banks in developing countries to lend to corporations in these countries.

Professor Griffith-Jones and et in the paper Basel II and Emerging Markets: The Case for Incorporating the Benefits of International noted that the adverse selection away from the Emerging Markets was against the expressed purpose of the Accord. In the study undertaken by the research group it was shown that the correlation between the risk and the extent of diversification in the loan portfolio was such as to generate real benefits with the inclusion of emerging markets. In a review of the loan portfolios of banks with internationally diversified portfolios (including loans emerging markets), relative to banks focusing on loans to developed nation the authors were able to show that the risk (defined in terms of unexpected loses) was much higher (about 23%) for those banks lending exclusively to developed nations.

The Basel Committee has shown a willingness to consider the benefits of diversification with respect to the treatment of small and medium enterprises (SME's). The rationale that the probability of default for a large number of SME's is lower than for a small number of large corporates is very similar to the argument for emerging markets. The region therefore asks the committee to reconsider the granularity argument as it relates to the treatment of sovereign debt for small (micro) open economies such as ours.

External Credit Agencies

The 2003 consultative package has continued to place considerable emphasis on the use of credit rating agencies. Most of the small indigenous and locally incorporated institutions in the Caribbean are not rated; in fact there are no rating agencies in our territories. Hence under the new framework these entities will carry a risk weight of 100%, resulting in a higher capital requirement for financial entities in these jurisdictions. Thus institutions and jurisdictions in our emerging markets will be placed at an unfair disadvantage to their peers in established/ developed markets. Additionally domestically incorporated institutions will also be at a disadvantage to the local branches of foreign institutions, which may have permission to use the advance approach to credit risk assessment. This will not address the issue of adverse selection and regulatory arbitrage (found in the 1988 Accord) as banks may continue to take higher risks so as to increase their returns and compete with their less capitalised peers. The simplified standardisation approach, which is the alternative offered to developing countries, whilst negating the need for the external rating agencies does not effectively address the underlying issues.

In addition, the accord will considerably increase the influence of external rating agencies on the lending decisions of international banks and by extension on the capital decisions of supervisors. These institutions are not regulated nor are their methodologies and processes sufficiently transparent. In addition some of their ratings have been criticised by analysts and, it has been argued, precipitated crises.

Operational Risk

Gross income has been retained as the basic indicator for the measurement of operational risk. This is not a useful indication in our markets as high net interest margins distort income such that it is not a good indicator of the level of operational activity. It is felt that the capital charge at 15% of gross income places an undue burden on banks in our jurisdictions. Additional research is required to find a better indicator of operational activity. The committee has issued guidance on the onsite analysis of operational risk and may want to consider the option of offering a range of values for the α and β measurements which are tied to the findings of the onsite inspection review.

The recognition of the impact of insurance mitigation impact on operational risk only under the Advanced Measurement Approach (AMA) heightens the negative impact of the New Accord on small domestic institutions. A review of the cost benefit relationship of adopting the advance approaches by small simple financial institutions may result in these institutions adopting the simpler approaches. This could result in small, operationally less complex, domestic entities bearing a higher operational risk charge than foreign owned internationally active institutions with more complex operational environments. Given this, the Committee may want to reconsider allowing an adjustment factor for insurance under the Basic Indicator and Standardised approaches so as not to unduly penalise small domestic entities. Under pillar II the supervisor will have the ability to increase the capital charge for such entities should it be determined that the entities operations are such that a higher charge is needed.

Cross Border Issues

The implementation of the New Accord will be especially difficult for our smaller jurisdictions with a mix of international and domestic entities. As with many developing countries, Barbados hosts a myriad of domestic branches of internationally active banks incorporated in different jurisdictions. The challenge for the national/local supervisor becomes harmonisation of the different national treatments imbedded in the New Accord by different host supervisors into a common interpretation. Co-operation between regulators will be essential.
This challenge will be faced by the national supervisor in both developed and developing nations, but the resource availability and the legal restrictions on

cooperation particularly as it relates to information flows from developed countries to the emerging jurisdiction, will be a challenge.

Human Resources

The new accord has as one of its tenets, the supervisory validation of the IRB and advanced measurement approaches. This raises the issue of higher technical sophistication of examiners as well as a need for well-qualified and technical staff within financial institutions. This competition for the same limited pool of technical staff will place tremendous pressures on the supervisors' ability to attract and retain staff of the highest calibre. In addition, the emphasis placed on the oversight by the board of directors and senior management implies that the knowledge-based standards must extend to these individuals as well. In many developing nations, the pool of persons meeting the requirements for directorship of financial institutions is limited. These requirements will further reduce this pool of eligible persons.