FB-656/2003 São Paulo, 31 de julho de 2003.

To
Basel Committee on Banking Supervision
BIS - Bank for International Settlements
Basle – Switzerland

Attention of the Basel Committee Secretariat.
By e-mail : bcbs.capital@bis.org

Ref.: The Third Consultive Paper on the Proposed New Capital Accord

Dear Sir,

On behalf of Febraban - Brazilian Federation of Banks - we are attaching comments on the third consultive paper on the proposed New Capital Accord.

2. Please feel free to contact us, if you require any further information regarding Febraban or the comments.

Cordially yours,

Gabriel Jorge Ferreira
President

FEBRABAN

COMMENTS ON THE NEW BASEL CAPITAL ACCORD (Basel II)

EXECUTIVE SUMMARY

July 2003

GENERAL ASPECTS

Compliments BIS for its work, specially the decision to extend the original deadline to get more feedback from institutions and interested parties.

Emphasizes the importance that the risk management issue will have after the implementation of the NBCA.

Recognizes the merits of the three-pillar framework and evolutionary approach to the methodologies. Each pillar focuses on a certain regulatory aspect in a supplementary manner, which must be harmonic in the implementation. Pillar I addresses minimum capital requirement, Pillar II banking supervision process, and Pillar III disclosure requirements for banks. The evolutionary approach enables institutions to choose capital calculation methodologies of increasing sophistication, both for credit risks and operational risks. Each choice must be validated by the supervisor and meet predefined criteria.

Recognizes difficulties in the implementation of Basel II, both by institutions and supervisors. Raises concern about the costs for process adequacy, especially by smaller institutions.

Suggests possibility of application of the current accord as an initial stage, a less sophisticate alternative, directed towards smaller and less complex institutions, always with the due consent of the supervisor.

Warns of the inadequacy of the proposal that events resulting from strictly operational risks, but recorded as credit risks, should continue in the operational loss database, though contributing to the capital requirement for credit; alignment of risk management to capital requirement should be emphasized.

Recommends more flexible limits for capital requirement reduction as a transition rule, otherwise it might discourage investments.

CREDIT RISK

Notes the effect of procyclicality of the models, recognizing the difficulty to address this issue.

Recommendations and considerations:

- Adoption of a local currency rule for rating, and not a global currency in certain cases.

- Define small and medium enterprise (SME) based on the form of risk management (individual or portfolio), and not based on sales
- Weights for rated customers should not exceed the weights assigned to unrated customers
- Extend the short-term attribute for banking transactions (interbank) from 3 to 6 months

Restates the importance of phases within IRB approaches (Foundation and Advanced IRB), to the Brazilian market

OPERATIONAL RISK

Recognizes the importance of including operational risk as a specific category, rather than the implied treatment currently adopted ("other risks").

Praises the more conceptual and less prescriptive tone adopted in the current document version.

Emphasizes the inconvenience of adopting as a risk proxy, indicators that are neither related to the level of risk exposure (gross income) nor to the institutions' environment of internal controls, recognizing the difficulties and costs of more evolved approaches.

Praises the inclusion of the alternative standardized approach, which is important to high margin countries. The approach does not contemplate costs, though also important.

Agrees with the exclusion of reputational and strategic risks in the Pillar I treatment, minimum capital requirements.

Warns of the inadequacy of the defined business lines to the Brazilian context, where institutions operate in a diverse manner.

Disagrees with the values suggested for the factors of the less sophisticated approaches. In addition to being high, they do not provide correct incentives to institutions migrate along the sophistication spectrum.

SUPERVISION AND TRANSPARENCY

Warns that the Committee's recommendation for banks to operate with capital above the minimum requirement confounds and unequally increases the costs of institutions, thus compromising the efficiency of the system as a whole.

Suggests a prompt definition of how data and models of institutions operating in different jurisdictions will be treated.

Suggests that the same rules be imposed on institutions operating in a given jurisdiction, regardless of the origin of capital and whether a main office or a branch.

COMMENTS ON THE THIRD CONSULTATIVE PAPER ON THE NEW BASEL CAPITAL ACCORD

São Paulo, July 2003

RISK MANAGEMENT COMMITTEE

INTRODUCTION

Febraban (Brazilian Federation of Banks) is the institutional body that brings together the community of banks operating in Brazil. Its member banks make up the vast majority of the Brazilian market using various ranking criteria: account for over 95% of consolidated Shareholders' Equity, over 97% of Deposits, and over 99% of the banks' Total Assets. Febraban is organized and equipped to deal with issues of concern to its members, including supervisory processes, regulatory and minimum capital requirements, which are currently being revised.

Febraban recognizes the effort, supports the initiative, and compliments the actual stage of the consultative paper (CP3) of the BIS Committee on Banking Supervision ("Committee"), which aims to improve the international framework governing bank leverage in the different jurisdictions. The decision to extend the original deadline, for further consultation and feedback, reflects the care the Committee is providing to the New Accord (Basel II). The current accord has fulfilled its purpose and has been a watershed for the international banking community, since it regulated the capital requirements and set minimum financial standards for institutions based on credit risk, later supplemented by market and liquidity risks, thus providing more even competition among internationally active banks.

The proposal being discussed will have even more profound implications. In an attempt to make the regulatory capital framework more risk-sensitive, the Committee will urge institutions to address effective risk management at the highest decision-making level in each institution affected by the new order. Supervisory review will end up encouraging banks to develop and use better risk management techniques in monitoring and managing risks. This is expected to create a more stable, regulated, and secure environment for banks' customers and users, as well as employees and shareholders.

Febraban singles out as strengths of the proposal in question: the three-pillar framework and the evolutionary approach to the methodologies. The Committee's choice to address the different aspects of the competitiveness issue, by dividing them into pillars, is one of the merits of CP3 and is suited to the Brazilian context, giving local regulators the option to fill any specific gaps, considering the advanced stage of many of the proposals already discussed in the current banking legislation, an example of which is the formal and periodic assessment of internal controls. The risk aspect involved in each pillar will be very clear to institutions and supervisors, leading to a uniform treatment across jurisdictions. It is important to emphasize the recognition by the Committee of the need for Pillars II and III, in addition to the minimum capital requirements addressed in Pillar I. Similarly, for the Brazilian market, an evolutionary approach using increasingly sophisticated methodologies for quantitative assessment of exposures, particularly the division into steps for implementation of the Foundation and Advanced IRB approaches, will allow institutions to evolve seamlessly as planned, with incremental investments and progressive results. It is worth noting that any institution will need to devote considerable effort to migrate from the Foundation IRB to the Advanced IRB methodology. The recognition by the Committee of the transition to effective risk management as a long-term process is crucial to those countries where collection and treatment of historical series, and implementation of sophisticated statistical models may be deemed incipient and limited to few institutions. In such jurisdictions, training and preparing supervisors to validate models and the like will demand time, focused discipline, and material resources. Requiring institutions to adopt a highly sophisticated treatment from the beginning would demand huge investments, that are hard to be properly planned and without the expected benefit in terms of effective risk management.

The attention given by the Committee to operational risk is adequate in all aspects. Not only because of its inclusion as the denominator in the risk-weighted capital ratio, but also commendable is the concern for improving the quality of the global risk management process of banking entities. The approach, supported by the models defined in Pillar I, is consistent with Pillars II and III. The effective application of the advanced measurement approaches, together with the best practices of identification, review, and control of the major threats to the processes supporting the institutions' different business lines, is no doubt the goal to be achieved. The contribution of the new accord in this regard is undeniable. However, some concerns have been raised about the effort required to implement it.

Febraban sends these comments to the Committee recognizing the merits of the consultative paper submitted for public discussion and suggesting improvements., The application of CP3 could be distorted in Brazil or may cause adverse effect on Brazilian institutions within the international context, due to some aspects of the current text.

GENERAL ASPECTS

In Brazil, like other countries, the financial market presents many diverse types of institutions and some degree of bank concentration. Large domestically owned institutions, both private and government-controlled, internationally active banks, and many other banks of different sizes and business areas operate and compete. Due to the size of the Brazilian territory and the sophistication of banking practices, an example of which is the modern payment system, the current complexity of many of the internal processes makes it difficult and expensive to make frequent changes in them. Therefore, the Committee is hereby encouraged to assist supervisors in previewing what will be required and from which kind of institutions.

As recognized by the Committee, through the various approaches available, there must be a number of solutions applicable to the different types of banks; and not just one solution. It would be recommended that each group of institutions have a risk-based methodology for determining capital adequacy, comparing the costs of determination and monitoring by supervisors to the benefits obtained in terms of security, prudence, conservatism, and operational efficiency. Therefore, it is questionable if smaller or less complex financial institutions need to change their current capital adequacy assessment model. Some institutions could continue to meet the regulators using the existing methodology. This segment of banks is expected to always contribute to the credit supply to the economy, and normally works with leaner cost structures. Thus, they are much more sensitive to the effects of regulatory requirements, likely to increase costs in a manner not consistent with the size and scale of such institutions. These institutions should not be required to bear undue costs or to migrate to a business scale not defined at the corporate level by their shareholders. In Febraban's opinion, many of the comments and discussions on the implementation of new controls and processes may impose inconsistent costs on many institutions, unless simpler methodologies are adopted, yet not less effective for the intended goal.

The current Accord, supplemented by local regulatory requirements, requires excess capital from a large part of the Brazilian institutions, in comparison with the international standards and actual identified risks. For Brazilian institutions, adoption of good management practices has long been required by banking regulations, which are conservatively prudential and applicable to all financial institutions, clearing houses, and other institutions that require a license from the regulatory body to operate. The portion of credit assets managed by smaller organizations represent just a small portion of the total assets of Brazilian institutions, which further justifies the suggested maintenance. The current model would be the initial stage, the less sophisticated option, but available to institutions that deemed it appropriate, always subject to regulatory consent.

Another issue to be highlighted, common to both Brazilian and international financial institutions, is the procyclicality inherent to all the models suggested in the consultative paper. Thus, whenever the economy of a country is doing well, capital requirements systematically tend to be low, and in bad times tend to increase, playing against the search for sustainable and stable growth, which is one of the goals of any government.

Febraban is aware of the difficulty of conciliating the solution of this issue with the best practices of prudence, conservatism, and operational efficiency, but submitting this solution for discussion and improvement of the regulations should form the background for the future capital requirement framework.

MINIMUM CAPITAL REQUIREMENT

As previously stated, the minimum capital requirement must be supplemented by the activity of the banking supervision body, and thus will not become the single qualification criteria. One of Febraban's concerns relates to the possibility of double counting risk events, for both operational and credit risk. In this particular, it is necessary to align risk management to the capital requirement against such risk, and a suggestion is that such events be also treated as operational risk for the purposes of capital allocation. The new proposition for operational risk factors, represented by loss events incurred in credit products, provides that those factors should be considered for the purposes of the operational risk management, however, should be regarded as credit risk for capital allocation. It is worth noting that there is no homogeneity or equality in the treatment between the loss database and the reference for capital allocation, because the basic principle of good risk management is to understand a loss record based on its causes and origins. Credit policies determine the prices of credit products by establishing procedures and controls necessary to assume essentially credit risks, based on the premise that such procedures will be strictly followed. In the event of losses arising from such failures, they must be linked to operational factors that are not evaluated at the time of lending, such as rating, behaviour, collateral, competences etc. and therefore, must be fully and uniformly treated as operational risk to ensure consistency from management to capital allocation.

In order to encourage adoption of more sophisticated risk management methodologies, with the subsequent capital requirement reduction, we suggest reviewing the capital floor by reference to the current requirement, since the investments necessary for qualification in the most elaborated approaches will have an extended time frame for presentation of all the benefits intended. The limit of capital reduction defined for the two first years of implementation of Basel II, at 90% and 80% respectively, reveals the Committee's chiefly conservative and cautious posture in reducing the chance of significant oscillations in the transition from the current to the proposed model. This concern can be deemed to inhibit the implementation and also to enable the necessary adjustments and testing by local supervisors. As previously stated, although recognizing its prudential effort, the definition of this limit creates, on the other hand, slowdown in investments designed to structure all the requirements imposed, since it will allow a capital reduction by only 10% per year for the effective period. In reviewing the overall cost-effectiveness of this investment, such limiting factor of reduction may be deemed discouraging.

Considering the calibration of Basel II tried to preserve the current capital requirement, the specific features of each jurisdiction of application of CP3, and the Brazilian context, Febraban believes the capital requirement levels have been set high. Minimum parameters should be established at less restrictive levels, and the Committee may suggest that the currently proposed levels be used as a reference, and not as minimum amounts.

CREDIT RISK

STANDARDIZED APPROACH

Febraban believes that an important portion of Brazilian financial institutions will use this approach. Based on the Brazilian market and the nature of some operations, Febraban identifies some necessary changes in the Standardized Approach:

(i) Rule to use the Local Currency and Global Currency rating: In distinguishing the risk evaluation for exposures with local and foreign settlement, it is important to make it clear that all credit operations with domestic settlement should be allowed to use the borrower's rating in accordance with the "Local Currency" approach, since there is no transfer risk involved in those cases. The borrower's "Global Currency rating" should only be adopted in case of operations with foreign settlement. Similarly to the approach to loans arising from MDB facilities, where the National Supervisory Authority can mitigate the transfer risk by using the borrower's "Local Currency rating", foreign trade transactions and facilities should receive the same treatment, due to the marginal occurrence of transfer risk for these kinds of transactions. The different pricing for foreign trade and purely financial facilities, defined by the market place is an evidence of the adequacy of the suggestion..

(ii) Concept adopted in CP3 to define SME: a survey conducted in the Brazilian market identified only about 2,000 companies having sales above 50 million Euros (~R$ 150 million). Thus, the total amount of lenders' exposure would mostly qualify as a SME exposure, notwithstanding the practice of financial institutions towards individualized relationship and analysis, with non-dispersed lending as typically performed to large companies (Corporate). Therefore, Febraban understands that the definition of SME concept does not suit the Brazilian situation. However, the definition of a concept by BIS involving also the form of risk management (individualized or portfolio) for the definition of an SME is believed to be more important than the mere definition of sales levels for this segment. Since the definition is really complex, a more general definition of SME, as mentioned above, could be used as a basis, however the regulatory body of each country could decide on the adequacy of the criteria in relation to sales.

(iii) Weight for Unrated Customer versus Below B- Customer

The establishment in CP3 of 150% weight for customers rated B- or below is inconsistent with the 100% weight adopted for unrated customers. This criteria would make companies in difficult situation prefer not to be rated by rating agencies as the rating would increase a company's credit cost (and consequently, the transaction cost), because the capital allocated to the worst rated companies would be higher than that for the unrated, which may lead to arbitrage. Unrated customers should have a weight of 100%, and companies rated below B- should be slightly above 100%.

(iv) Concept of Short Term Banking transactions

Option 2 Banking transactions having maturity of less than 3 months are considered short-term transactions and are weighted up to 20%. Considering that a large portion of transactions of this kind has maturity of more than 3 months, Febraban suggests this term be extended to 6 months in order to better suit the Brazilian context.

IRB METHODOLOGY

Febraban recognizes that different Brazilian institutions or operating in Brazil will adopt sophisticated methodologies, especially the Foundation IRB Approach. It is important to stress that this approach is a necessary step in the process of learning and investing in the infrastructure demanded by CP3, with effective and immediate results. The implementation of the second step, i.e. requirements of the Advanced IRB Approach, will certainly demand significant investments and time from all Brazilian institutions.

Febraban also understands that the historical data base encompasses data that still need further discussion. Accordingly, we suggest a more flexible time limit on availability of past data in order to enable greater adherence to IRB practices.

OPERATIONAL RISK

Febraban praises the inclusion of operation risks among the Committee's concerns because, in it´s belief, this type of risk is an ongoing threat to institutions in general and particularly banking institutions. However, Febraban recognizes that the quantitative treatment is a challenge to risk-managers and supervisors, hence some skepticism as to the efficiency of the Pillar I treatment. The shortcut found, which consists of requiring capital based on the institutions' gross-income, is known to have no relation to the actual risks incurred nor to the existing controls designed to counter such risks. The power of officers in this respect becomes much more important than the treatment of credit and market risks, leaving it to the discretion of supervisors to check the qualification on an empirical, punctual basis, hard to compare to other institutions and jurisdictions. Accordingly, Febraban wants to emphasize the suggestion to reduce the importance of minimum capital parameters, thus minimizing the impact of any incorrect evaluations.

Regarding the intended improvement of processes, resulting for better risk management practices, Febraban stresses that the adoption of a percentage on revenue does not necessarily reflect the exposure of a financial institution to operational risk, Moreover, the existence of a linear relationship between gross-income and operational risk exposures has not been established. The proposed capital charge should be seen solely as a buffer for losses resulting for unintended exposures. The regulatory compliance procedures allied with the procedures developed in each institution for management purposes, the monitoring of operational losses, and even the management provision for these disbursements corroborate the suggestion to reduce the parameters applied to the indicators chosen by the Committee as proxy of operational risk. In the preparation for the quantitative impact studies (QIS), it was clear to participating banks the dimension of the simulated excess compared to historical values, which include the losses arising from legal risks.

The treatment of operational risk exposures under Pillars II and III seems more appropriate than under Pillar I. The qualifying criteria proposed in the document address this in a very objective way, without quantifying the exposures. In this regard, Febraban applauds the change in the tone of the document, more conceptual and less prescriptive, as evidenced by the abandonment of the internal measurement approach (IMA), mentioned in preliminary versions of the consultative paper. It will no longer be the responsibility of regulators to impose specific quantification methods in the more advanced approaches (AMA), and the institutions that consider themselves capable will be requested to demonstrate the efficiency of the methods to their supervisors. These degrees of freedom extended to institutions, however, must be accompanied by the due training of banking supervision bodies and professionals, a considerable challenge in view of the proposed effective time of the new order.

For example, we refer to the collection of loss data. Although systems of collection of losses are currently used by a number of institutions, for a better utilization of these systems and their data, more time is needed for review and consequent validation, in view of the definition of models. We do not want to state that Basel II should be implemented only when all the huge amount of variables associated with operational risk is known, but it is essential that the models reach a greater level of maturity than that currently existing.

Important aspects on operational risk exposures were intentionally excluded from the regulatory framework in it´s Pilar I, namely reputational and strategic risks. Febraban agrees with the exclusions and recognizes that the quantitative treatment currently available would be even more distant from the actualrisk exposure if these reservations have not been previously addressed by the Committee.

BASIC INDICATOR APPROACH

Despite the calibration efforts of BIS, through quantitative impact studies, in which various Brazilian institutions participated, Febraban recommends that the incentives for the use of more sophisticated approaches be more encouraging. The costs arising from the use of the standardized approaches or advanced approaches (AMA) are far above the difference in the capital requirement under the basic indication approach. Thus, if the current calibration of the "alpha" factor is maintained, Febraban suggests the Committee to revise the calibration of the "beta" factors under the standardized approaches, lowering them.

STANDARDIZED APPROACHES

Brazilian institutions are internally structured in a very different manner from that outlined by the Committee, especially regarding centralization of support activities, the processes of which may also cause operational risks losses. The calculation of revenue in each of the lines can be arranged without major difficulties, but the criteria for assignment of losses to one or other line will compromise the process and make it questionable. Since systematic monitoring of losses is part of the qualification requirements, Febraban views this point with apprehension.

The Committee's efforts to calibrate the parameters used in the models are commendable, however, as seen from the results of the different QIS promoted so far, especially in the basic indicator and standardized models, there are undeniably differences in the macroeconomic environment of the participating countries. Another factor to be taken into account is the wide rage of revenue presented by the institutions surveyed, which stresses the concern about possible discrepancies between the regulatory capital measured using such models and the efficiency of the risk management practices promoted by institutions. In this sense, introducing the Alternative Standardized Approach (ASA), the Committee had addressed the question in a very suitable way. However, this option should not appear as a footnote. As an alternative avaiable to banks, it should appear in the body text.

ADVANCED APPROACHES

Requiring the adoption of a Management Model for a bank to qualify to the AMA, and not only a Quantification Method, represents a great change in CP3. Even this Management Model was not explained, only the requirement to adopt it, and may be used upon validation by supervisors. This approach is commendable, since risk management is much more than simply risk measurement, and requires compliance with the basic principles of an effective operational risk management.

The Committee's consultative paper no longer explains advanced measurement models, as in the previous one and other documents on operational risk treatment, but imposes extremely rigorous criteria for a bank to qualify to use the advanced methodologies.

The Committee opens the possibility of some banks in some countries adopting an alternative (less complex) model to the AMA. Because the Basel II has global scope, it is clear that in some countries banks will not be able to fully adopt the LDA (loss distribution approach), particularly in the so-called emergent countries. Thus, adoption of a combination of the LDA with other risk evaluation tools may be accepted by the banking regulator in some countries.

PILLAR II - BANKING SUPERVISION PROCESS

Aware of the overcharge in the activities of implementing Basel II and the need for conceptual and technical leverage as required by the issue, we deem it very advisable that the BIS supports the supervision entities through technical support, and preparation of directives and punctual orientations to guide their actions. The requirement of management models for the treatment of risk, in addition to the quantification methodology, becomes much more effective to the extent that it demands reasonable training of the supervision.

Still on the issue of banking supervision, it is important to mention and disclose as soon as possible, what would be the eligibility criteria for banks so that there is a balance in relation to costs. The efforts of requiring capital, particularly from smaller banks, and encouraging the credit supply in the economy can be completely opposite, thus making void the intended expansion.

Additionally, with respect to the criteria for local adaptation to Basel II, Febraban is concerned with the maintenance of conservative practices adopted by regulatory bodies that could define allocation percentages above the current minimum (8%), as an additional safety margin, which could compromise the efficiency of the system as a whole.

Finally, Febraban, concerned with the symmetry in the domestic financial market, understands that any rules imposed on Brazilian financial institutions should be extended at the same level to foreign-owned institutions when operating in Brazil.Any distinction in treatment would imply a serious distortion in the requirements to determine the capital for institutions based in Brazil, in addition to imposing high costs on regulatory bodies, difficulties in supervising procedures and checking compliance. Accordingly, the treatment for databases and models used by the same institution operating in different jurisdictions must be indicated as soon as possible. The costs for preparing validations with multiple supervisors, in addition to the complexity of gathering and reviewing data from diverse macroeconomic environments and meeting equitable treatment conditions with the other institutions operating in each jurisdiction, is a considerable challenge to the implementation of the New Accord, both for banks and supervisors.