31 July 2003

Basel Committee on Banking Supervision
Secretariat
Bank for International Settlements
CH-4002 Basel
Switzerland

Dear Sirs

**Third Consultative Document on New Basel Capital Accord**

The Hong Kong Association of Banks is a statutory banking association which represents the interests of all fully licensed banks in Hong Kong, the great majority of which are headquartered outside of Hong Kong. It is pleased to submit the comments of its members to the Basel Committee on Banking Supervision (Basel Committee) regarding the proposed New Basel Capital Accord (Basel II) set out in the Basel Committee's third Consultative Document (CP3). We understand that some of our members have submitted their own detailed comments to the Basel Committee. This submission therefore attempts to reflect the general flavour and tone of our members' general concerns with its emphasis on specific Hong Kong and Asian issues.

1. Cross-border Implementation

We support the efforts of the Basel Committee to create a more risk-sensitive regulatory capital framework for banks and we recognise that Basel II has taken account of industry feedback on previous drafts and has incorporated many changes for the better. However, we do not believe that Basel II arrives at an appropriate balance. The large number of alternative approaches and national discretions is potentially a cause for major concern for international banks. Firstly, it imposes additional operating costs on the banks. Secondly, it carries the corollary that banking groups' total capital will be the sum of whichever is the higher of home and host requirements throughout their geographic spread rather than an objective assessment of their capital needs on a consistent basis. These in turn could lead banks to conclude that marginal businesses in smaller, emerging economies were not worthwhile, discouraging competition and the spread of best practice.

Another key concern is whether the local supervisor will have the resources and expertise to adequately assess and validate banks' international models. We are also concerned that some national supervisors will be more conservative in the interpretation and application of the Accord, while others will operate a more lenient approach. The consequence of differences in implementation requirements for each national supervisor is not only the potential cost to both supervisors and international banks, but also the risk of competitive distortions through the creation of an unlevel playing field across regions.

These difficulties could be reduced without impairing the quality of supervision or development of banks' risk management by adjusting the balance from rigid, prescriptive risk management methodologies towards a more principles-based approach. Further, reducing the number of local regulatory discretions, and standardising rules within the different Pillar 1 calculation approaches wherever possible, would help to reduce the burden of compliance. Finally, we believe that national regulators should accept the principle of deferring to the lead regulator of a banking group that is subject to multiple regulatory jurisdictions, or else consult with the lead supervisor and agree a common approach. This will avoid the significant additional costs of multiple interpretations that are, of themselves, likely to produce no risk management benefits. This is likely to be particularly important to the implementation off Pillar II, where we consider it most likely different regulators will take different approaches.

2. <u>Pillar II</u>

We consider that a consistent and transparent application process is needed for Pillar II, the area of the proposed Accord that is most likely to influence a level playing field.

We are concerned that Pillar II add-ons may be used to penalise banks, who, for good commercial reasons, choose to adopt the Standardised approach. Further, we are concerned that this may also be used to force banks to adopt the more advanced approaches across all exposure categories and geographical locations even where lack of data or materiality does not justify this commercially.

We consider regulators should leave the choice of approach entirely to the banks, even if this choice is to adopt a Standardised approach. We support regulators adopting a systematic and transparent approach to the calculation of Pillar II add-ons. We also support close liaison between regulators to ensure a similar implementation approach is adopted in all jurisdictions.

3. <u>Pillar III – Disclosure Rules</u>

The three-Pillar approach of the new Accord; supplementing minimum capital requirements with the qualitative factors of supervisory review (Pillar II) and market discipline (Pillar III) is well accepted. However, much of the detail and prescription in the Pillar III market disclosures continues to give cause for concern. The additional requirements are more likely to confuse than illuminate readers. The efforts made to achieve agreement with the industry are recognised, but we prefer to see an approach based on general principles with qualitative guidelines, and perhaps supplemented by worked examples, to the current prescriptive rules. This will allow banks to provide disclosure more directly relevant to its own risks, and will aid reporting of future developments in risk management practices.

We note that the Basel Committee has forged closer links with accounting standards setters, and we believe this should be encouraged and further developed. However, there are differences between accounting disclosure rules, both current and proposed, and what is required under Pillar III. These differences need to be eliminated to avoid confusion for readers of accounts.

4. <u>Conservatism</u>

(a) The calibration of the IRB approaches under Pillar 1 has been based on the application of a simplified form of credit model. Our understanding is that, like most statistical models of risk, this model uses estimates of mean and variance in order to produce a required level of capital to cover tail risk. We are concerned that some aspects of the minimum requirements will result in banks being forced to bias their inputs away from the true mean and towards a "stressed" estimate. While there may be a place for stress testing within a bank's overall risk management, using stressed inputs to a model calibrated on a non-stressed basis will result in vastly over-stated capital requirements. The inputs should represent a bank's best estimate of normal circumstances.

An example of this is found in paragraph 430. We agree with the use of a default-weighted average for LGD but do not see the relevance of the additional requirement that "the bank must use LGD estimates that are appropriate for an economic downturn". We believe this is both conceptually wrong and practically burdensome. As most defaults occur in periods of economic downturn, a bank's average recovery experience will automatically be weighted towards such periods and to require a yet more extreme "worst case" calculation makes the calculation unreasonably conservative.

The same applies to the requirement for EAD to be appropriate for an economic downturn, contained in paragraph 437.

A similar, practical issue is found in paragraph 409 where "PD estimates must be a long-run average of one-year realised default rates in the grade". A bank will wish its grading scale to display monotonically increasing PDs. It makes no sense for a "better" grade to be associated with a higher PD. In practice, though, it is not at all uncommon to find that there are inconsistencies. For example, the observed default rate for Standard & Poor's A+ rating is higher than that for the A-rating. This does not mean that we should regard A- as a better rating than A+: it is simply a reflection that default data is noisy and needs to be interpreted with an element of judgement and not in accordance with inflexible rules. We recommend that paragraph 409 should be rephrased to require that the performance of the rating system taken as a whole should be in line with actual experience, rather than a requirement relating to individual grades.

(b) The current Pillar II proposals include a credit risk " stress test" which is directly linked to possible additional capital requirements. The exact design of this test remains unclear but the language suggests it amounts to an extra layer of buffer capital so that banks will not need to dig into their core capital in tough times. The cumulative effect of the proposed Pillar I and Pillar II requirements would always reflect adverse circumstances regardless of their current conditions. There would also be the question as to what minimum level the buffer should be allowed to fall when conditions do deteriorate – how bad a slump should the buffer accommodate?

(c) We suggest that the Basel Committee add to the proposed Accord an explicit acknowledgement that capital levels may fluctuate, and that Pillar II reviews and stress tests do not become ratchets that only increase regulatory capital requirements. If a stress test is to work properly, then when tough times arrive, banks should be permitted to live within their plans, and regulators should resist the temptation to continue to require the capital cushion to be maintained untouched. Otherwise, Basel II’s stress test will not reduce pro-cyclicality, but will simply amount to an unpublished higher minimum capital standard. This will have the effect of generally increasing the amount of capital in the system, against the stated objective of the Basel Committee, and will further drive some areas of business to non-regulated financial entities.

5. Operational Risk

The introduction of a new explicit capital charge for operational risk has proved to be the most controversial element of the proposed Accord, particularly in the Asian region as it will almost certainly result in overall increases in capital requirements in the region as the majority of banks are likely to adopt the STA.

It is important to distinguish between the concepts of managing operational risk and imposing a separate, quantitative capital requirement for it. We agree that evaluating and controlling operational risk is important and should be required as a supervisory and business matter. In our view, operational risk can best be addressed through case-by-case supervisory reviews under Pillar II.

We do not believe that operational risk can be modelled in the quantitative way proposed under the Basel II rules. Many efforts to measure operational risk have been proposed, often focusing on limited areas (e.g. operations processing losses) that happen to be susceptible to statistical techniques. However, these methods are not generally relevant to major risks, such as fraud, a changing legal environment or a major disaster, which are the risks that require capital. Operational risk capital is primarily to insure against the risk of being fundamentally affected by a major event, but it is difficult to predict and measure the unexpected.

Basel II and other regulatory initiatives will push banks to devote significant resources, which could otherwise be better utilised elsewhere, toward operational risk systems and loss databases. Basel II’ s Advanced Measurement Approach (AMA) to operational risk requires banks to attempt to verify their models statistically to a standard which covers events which may occur once in a thousand years. The futility of attempting this is obvious. By emphasising quantitative numbers for operational risk, we may be creating a false sense of security that we have measured operational risk and hence controlled it.

We continue to have concerns as to the calibration of the operational risk proposal. We would highlight the calibration of business line beta factors for corporate finance, trading and sales, and payment and settlement at a level above the alpha proposed in the Basic Indicator Approach (BIA). We would prefer a calibration with clear incentives to adopt the STA and where beta factors do not exceed the BIA alpha.

We believe that there is economic value in operational risk mitigation products, and that this should properly be reflected in the calculation of any regulatory capital charge. The Basel Committee proposes the recognition of insurance in the AMA but not under either the BIA or STA. We believe that recognition should also be possible in principle in the BIA and STA. It would be preferable, and more consistent, if the Basel Committee articulated the principles which should drive recognition and valuation.

Subject to national discretion, banks may adopt an Alternative Standardised Approach (ASA) if they are able to satisfy their supervisors that it provides an improved basis of measurement by, for example, avoiding the double-counting of risks. The “m” factor of 0.035, or 3.5% of loan balances, is too high for banks in Hong Kong especially for commercial business lines given the narrowing interest margins and persistent low interest rate environment. Clearly this approach favours business lines where spreads exceed 3.5%. Our main concern with this approach, however, and the practical implementation of it, is that it will further add to level playing field issues.

We believe that while most Hong Kong banks will initially adopt the two simpler approaches, in the longer term, more technical support and guidance from the Basel Committee and local regulators is required to ensure a smooth transition from the STA to the AMA.

6. <u>Thresholds</u>

In a number of places in CP3 (e.g. paragraphs 199, 200, 202, 242), thresholds are specified that will result in business being subject to a different classification or treatment according to which side of the threshold it falls. The thresholds are fixed in monetary amounts without any provision for revising these in line with inflation or exchange rate movements. This could create difficulties for business that falls close to the threshold as a result of short-term exchange rate fluctuations. For example, an exposure to an individual of GBP70,000 is less than EUR100,000 at an exchange rate of EUR1.42=GBP1 but above it at EUR1.43=GBP1.

Similar considerations apply to portfolios where the overwhelming majority of the constituents fall on one side of a threshold but a small proportion fall on the other side. CP3 does not recognise this possibility but appears to assume that all bank portfolios will simply comply with these arbitrary regulatory thresholds. We believe that this is unnecessarily restrictive. It is easy to foresee cases, for example, where banks would normally treat a small borrower under a retail credit process but – not having access to the accounts of other companies in the same group – would be unable to prove that it met the group turnover criterion for recognition as SME.

Both problems could be substantially alleviated by allowing a small level of exceptions. We suggest that portfolios could be regarded as qualifying for a particular treatment provided at least 95% of their constituent parts meet the criteria. Similarly, once an exposure has been allocated to a particular class, it should not be reclassified as a result of exchange rate movements unless they take it more than 10% above/below the appropriate threshold. The use test could be employed to ensure that this concession was not being abused.

7. Maturities

Similar problems occur in those instances where treatments differ according to the maturity of an obligation. Though some "cliff effects" may be inevitable, it is important that their introduction does not conflict with existing market practice. Accordingly, we recommend that maturity cut-offs relating to, for example, a period of "three months" should always be expressed as being inclusive of exposures of exactly that maturity and not end one day short of it. While this is sometimes the case (e.g. paragraph 38 "original maturity of 3 months or less"), it is not always so (e.g. paragraph 291 "original maturity below three months"). We see no reason for this inconsistency and believe that introducing a regulatory cut-off that conflicts with already well established market conventions should be avoided.

8. Data Quality Issues for IRB Approaches

The IRB model implicitly assumes the availability of default, loss and exposure data. In Asia, this assumption is flawed now, particularly in respect of corporate lending, and this is likely to continue to be the case in the near future. There are concerns about the reliability and timeliness of corporate financial statements due to different accounting, auditing and regulatory reporting standards within the region, and this will clearly impact on assessment of PD. This is a hindrance for early adoption of IRBs in Asia. There are also likely to be insufficient loss and default data to support meaningful assessments of LGD. Furthermore, what historical data are available for the calibration of PD and LGD are not available generally in an easily assessable way for further analysis. This will severely hamper the development of any statistically meaningful corporate credit scorecards.

9. Recognition of Physical Collateral

Although greater recognition of physical collateral under the foundation IRB approach is available under CP3, we suggest that the STA should also recognise real property (including income producing/investment property which is related to the loan it collateralises) and other categories of physical collateral (e.g. ships, aircraft, trains, plant and machinery, equipment, factored receivables, commodity inventories relating to the loans they collateralise) subject to appropriate, jurisdiction specific, objective standards regarding legal enforceability, and supervisory established haircuts to adjust for risks of documentation, valuation and liquidity. This is to ensure fair treatment across the standardised and IRB approaches so that all banks receive regulatory capital recognition for prudent risk mitigation activities.

10. Claims on Banks under the Standardised Approach

Under Option 2 for the treatment of claims on banks, those banks with external ratings in the range A+ to A- will be allocated a risk weight of 50%. This is considerably more than is economically justified and considerably more than would be implied under the IRB approach, which would give a weight of around 30%. This discrepancy might not be of great significance if the majority of interbank participants use an IRB approach when evaluating their counterparties. We are concerned, however, that the lack of historical default data for this sector may mean that many banks adopt the STA for this portfolio. The impact on the relative attractiveness of A-rated banks as against AA or AAA alternatives would then be dramatic and could cause significant changes in market activity. It would be highly undesirable for such a shift to be triggered by a regulatory decision that is not supported by real differences in risk. Accordingly, we suggest that a weight of 30% should be applied to A-rated banks under Option 2 of the STA.

11. Treatment of EAD under Standardised Approach

The application of a 75% credit risk conversion factor (CCFs), which are only 20% to 50% respectively for different maturity under the STA, might discourage banks from adopting the IRB Approach. It seems to be more appropriate to apply a 50% CCF for the IRB Approach.

12. Definition of Specialised Lending Exposures

The five Specialised Lending Exposures (paragraphs 189 -194) are intended to cover projects of significant value. However, we are concerned that many small businesses in the Asia Region, which do not qualify as SMEs but may have collateral as the major asset of the company and rely on the asset for source of repayment, would be caught under these five categories. We believe that only loans exceeding a certain threshold are to be classified as Specialised Lending Exposure. The threshold should be allowed to be set to reflect the local circumstances.

13. Securitisation

A BB rated direct corporate exposure would attract a risk weighting of 100% whereas under the STA, a low quality tranche which is also BB rated is risk weighted more heavily at 350%. Clarification is sought.

We support a risk sensitive approach to capital adequacy and the formulation of clear standards and procedures for cross-border implementation of Basel II in order to avoid conflicts with banks' established risk management processes and to ensure that unintended consequences are minimised. We hope to contribute to the continuing debate in this area.

Yours faithfully

Rona Morgan
Secretary

c.c. Hong Kong Monetary Authority (Mr D T R Carse, Deputy Chief Executive)