Comments and proposals of the Hungarian Authorities concerning the third Consultative Document of the New Basel Capital Accord

The Hungarian Financial Supervisory Authority and the National Bank of Hungary (hereafter: the Hungarian Authorities) after consultations with market participants, make the following comments and proposals concerning the third Consultative Document of the New Capital Accord issued by the Basel Committee on Banking Supervision in April 2003.

The Hungarian Authorities agree with the main objectives of the New Capital Accord recommendation, namely to adjust the regulatory capital requirements to the real risks undertaken by a bank in a way, that takes into account the new risk management techniques and risk mitigation methodology applied by the bank. The Hungarian Authorities also acknowledges the importance of reaching the original objective of the New Capital Accord, i.e.: to maintain the present level of available capital in the banking sector. Hungary has participated in the QIS3 exercise because of this consideration. The proposal presented in the third Consultative Paper has evolved substantially taking into account the experience and, in our view, it needs only slight amendments in a few points and some fine tuning.

Pillar 1: Minimum capital requirements

Credit risk mitigation

The draft of the New Capital Accord recognizes a wider scale of risk mitigating instruments compared to the 1988 Recommendation. The recognition of those instruments increases significantly the risk sensitivity of the regulatory capital requirement. Because of prudential reasons it is obviously important to set up the criteria of recognition related to these instruments. However, due to the strict rules, some instruments which are used in some countries in a widespread manner may have been remained outside from the recognizable risk mitigating instruments. It would be especially important for the banks of certain countries that the Accord should recognise the simple surety of the central government (sovereign) when assessing the capital requirements, since this instrument, which is used widely also in the Hungarian practice, results in fact in lowering the risk. The central government (sovereign) surety only in exceptional cases means cash surety as recognized instrument in the regulation

> ***The Hungarian Authorities suggest therefore, that the New Capital Accord should give the option for the supervisory authorities to recognize partially the simple surety of the central government (sovereign) even though this simple surety fulfils only partially the strict criteria defined in advance.***

Those non banking institutions which were established deliberately for the purpose of guarantee provision and do not operate as banks, however which are usually backed with a solid government support, fall under this case as well.

The Hungarian Authorities suggest, therefore, that the guarantees provided by guarantee institutions may be recognised by the supervisory authority as risk mitigating factor up to the amount of the counter-guarantee, provided that this counter-guarantee is granted by the central government.

Internal rating based approaches

The partial adoption of IRB approach

The present version of the draft New Capital Accord requires that a bank once adopted a partial IRB approach, it is expected to extend it across the entire banking group to each significant class of assets and business line. The Committee allows to implement the IRB approach gradually (phased roll-out), but does not permit the partial use of the IRB approach for significant asset classes and business lines.

The Hungarian Authorities propose: In order to disseminate the more risk sensitive methods and to avoid the regulatory arbitrage, the partial implementation of the IRB approach should be allowed related to more types of significant portfolios, of course, when fulfilling the strict requirements.

This process is allowed in the relevant draft EU directive, and when fulfilling certain conditions the standardised approach could be applied permanently to claims on sovereigns and financial institutions in parallel with the advanced approach applied to other asset classes.

Common database

The Consultative Document does not give detailed guidance on the criteria how to establish a common database (data-pool) by banks or banking groups which operate in one country or in more countries, and the data of which can be used in the framework of IRB approach when assessing the capital requirements.

The Hungarian Authorities suggest that the New Capital Accord should indicate item by item the detailed elements related to the similarity of the rating systems (e.g. Should the applied indicators and their weights be the same or is it sufficient to adjust the indicators to country weights or the applied indicators themselves can differ?)

It is crucial in the establishment of a common database whether it can be created by any group of banks or should any limitation be set up there. It is an often raised question in international fora whether it is allowable for banks in a competitive position to establish a common datapool. While the opinions of experts are quite divergent in this question, we request the Committee to indicate its position on this issue

The Hungarian Authorities propose to the Committee to explain in details the requirements related to the common database, such as requirements to be applied

when assessing the similarity of databases and those banks, which establish a database.

Revolving retail exposures

Within the retail portfolio the Consultative Document defines a different risk curve to be applied to the revolving exposures, which takes into account, that in the case of these asset classes the future margin income (FMI) covers the expected losses. However, the criterion for the recognition of FMI is fulfilled in case of other types of retail exposures as well, so the exceptional treatment of the revolving exposures exclusively does not seem reasonable.

The Hungarian Authorities suggest the extension of the procedure to each subclass of retail exposures fulfilling the FMI recognition criteria, since the regulation in its present form may lead to the modification of the product structure of banks.

Exposures to Small and Medium size Enterprises

In each of the three approaches (standardized, foundation and advanced IRB) which aims to define the capital requirement of credit risk, the required 1 million Euro exposure limit to be qualified as retail and the 50 million Euro total annual sales in the IRB approach for the firm-size adjustment causes different outcomes in different countries with different corporate structure. In these countries – such as Hungary – whose economies are characterised by smaller companies, the category of large corporates may be almost fully emptied.

In the opinion of the Hungarian Authorities, it would be reasonable to modify the defined limits in order to take into consideration not only the corporate structure of the biggest economies.

Connection between loss provisions and the regulatory capital

The rules related to the loss provisions in the draft New Capital Accord serve the purpose that the regulatory capital and the provisions together cover the expected (EL) and unexpected losses (UL) of the credit portfolio. At the same time however, the devaluation and risk provisioning regulations of countries differ in many respects, which encumbers the unified treatment of those in the present proposal. The Hungarian Authorities consider it important to harmonize the regulation of this area in the future, and to elaborate unified devaluation and risk provisioning standards. However, it is obvious that this aim exceeds the framework of the present New Capital Accord. The harmonization of this set of regulation with the present IAS standards - which regulate internationally the accounting of impairment and loss provisioning – should also be assured. The IAS standards usually give only the most important principles of evaluation, and the Committee may be an appropriate forum to define more detailed rules of devaluation and provisioning.

For defaulted assets, any amounts of specific provisions and partial write-offs that exceeds the EL capital charge may be used to cover the EL capital charge of other defaulted assets in the same asset class. In that way the approach focusing on individual credits before default is replaced by a portfolio based approach after default. When calculating capital requirement, the creation of specific provisions equal to the value of LGD has a fundamental importance for banks, because in this way the capital charge of the defaulted asset becomes zero. Hence the

LGD has a key function, while in the moment of default its value is uncertain. On the other hand, in the IRB Foundation approach the fixed LGD values are based on the average of the G10 countries, therefore they do not necessarily reflect the real value of the client portfolio of a given country. Taking into account these discrepancies we find it inadequate to rely on a standard LGD value when assessing the capital (and provisions) charge of defaulted assets.

> ***The Hungarian Authorities suggest, that the Committee should deal with the issue of defaulted assets and should explicitly mention that in the case of defaulted assets, the supervisory authority may require additional capital in excess of Pillar 1 requirements.***
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> ***Furthermore, the Hungarian Authorities suggest to formulate explicitly in the text that the re-allocation of provisions in the IRB Advanced approach may be only accomplished in the case, when the LGD equals either to an average value of a portfolio or sub-portfolio or to an average of an economic sector.***

In our view the regulation in its present form encourages banks to generate the loss provisions equivalent to value of LGD in the shortest time, however, they do not support the generation of a higher value.

Operational risk

The draft New Capital Accord recognises the risk mitigation effect of insurance against operational risk only in the case of the Advanced Measurement Approach.

> ***The limited recognition of insurance as risk mitigating instrument should be allowed in the simple methods as well if certain criteria are met, since the amount of loss, which should be covered by the capital charge related to operational risk, is always reduced by the use of risk mitigating instruments. Of course, the recognition of insurance as a risk mitigating factor in the assessment of capital charges has to be conditional on the fulfilment of well defined criteria, such as: the definition of insurance companies whose insurance are acceptable, how to take into account the amount of retention when assessing the capital charge, or what terms are to be included into the insurance policy.***

Once the risk mitigating effect of insurance is not recognised by the Committee, it would mean a double capital charge, since the same risk is covered by capital or reserves by banks and insurance companies as well.

Pillar 2: Supervisory Review Process

Scope of application of Supervisory Review

The New Basel Capital Accord will be applied to internationally active banks at every tier within a banking group, not only on a consolidated basis, but equally on a sub-consolidated and individual basis. Under Pillar 2 supervisors should review and evaluate banks' internal capital adequacy and ensure that they are operating with adequate capital levels commensurate with their risk profile. It is not clear in the draft, however, on what level the competent authorities should carry out the supervisory review process. Pillar 2 mentions explicitly only the capital adequacy *of individual banks*.

> ***The Hungarian Authorities suggest to clarify in the text the level of supervisory review process, that is to determine on what level of consolidation supervisory authorities should fulfil their task.***

Capital Adequacy Assessment Process

Under Pillar 2 the Committee identified four key principles of supervisory review, but does not give any further guidance on their implementation. It would be especially important for banks to have an indicative/minimum list of factors to be taken into account (still leaving a substantial freedom for them) in the internal assessment of their overall capital position, facilitating the supervisory evaluation process alike. In some countries, including Hungary, most banks have not developed yet their capital adequacy assessment processes and to facilitate their preparatory work for the adoption of the New Accord, they need further guidance from the Committee on this issue.

> ***For the above mentioned reasons the Hungarian Authorities propose that the Committee should elaborate more detailed guidance on the internal capital adequacy assessment process of banks.***

Scope and transparency of national discretion

In view of the Hungarian Authorities, the current proposal still allows for such a wide range of national options that may endanger the coherent application of the New Accord globally and can result in the geographical realignment of business activities. Having accepted the need for supervisory discretion allowing for taking into account the specificities of local markets and enhancing competitiveness, the Hungarian Authorities still believe that the current number and scope of national discretions is too wide and should be limited. This limitation would encourage the coherent application of the New Accord and would help to avoid competitive distortions and regulatory arbitrage.

The Hungarian Authorities also find very important, as well, the transparency of decisions taken at national discretion in different jurisdictions to make regulatory differences more visible. Supervisory disclosure would promote the harmonisation of supervisory practices and the recognition of preferential treatments.

> ***In order to promote the coherent application of the New Accord, and to enhance the transparency of supervisory discretion as well, as to treat the arising implementation problems, the Hungarian Authorities propose to enlarge the membership of the Accord Implementation Group by delegates of non G-10 countries applying the New Accord.***

Risks not addressed under Pillar 1

In the view of the Hungarian Authorities there are some types of risks under Pillar 2 which assessment and determination of the corresponding capital requirement should not be part of supervisory discretion (bank specific). The HFSA and the NBH believe that the capital requirement of interest rate risk in the banking book and the residual risk of credit risk mitigation techniques along with the requirements concerning stress tests could be determined by national discretion (country specific) more effectively. However, to ensure a level playing field, the Committee should propose an explicit mandate to treat these risks by national discretion.

The Hungarian Authorities find that these risks should be separated from other risks under Pillar 2 (concentration risk, operational risk, securitisation risk) and the further elaboration of the corresponding requirements by the Committee would be essential.

> ***The Hungarian Authorities propose that the capital requirements of interest rate risk in the banking book and the residual risk of credit risk mitigation techniques should be treated as minimum requirements of Pillar 1, its violation would automatically trigger supervisory action. We agree with the fact, however, that these risks cannot be treated by international standards only and national specificities also should be taken into account.***

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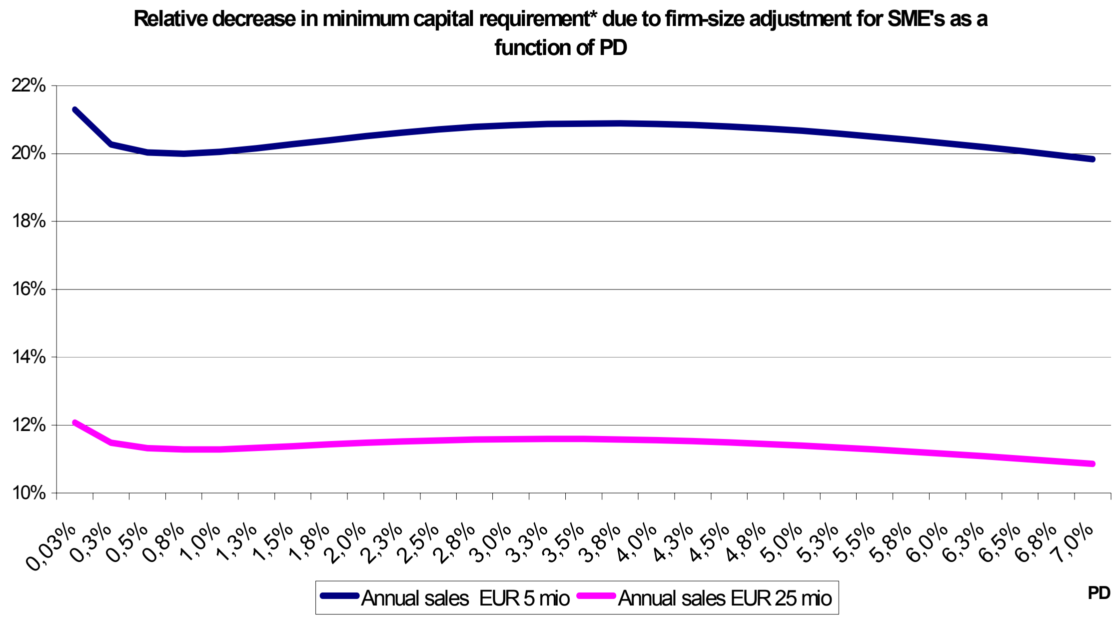
We are convinced that the further consideration of proposals of the Hungarian Authorities would contribute to the smooth introduction and implementation of the New Capital Accord and with narrowing uncertainty in the present draft the global adoption and implementation can be accelerated.

A methodological problem

The Basel II proposal supports in different ways the SMEs' lending. Under the IRB approach for corporate credits a firm-size adjustment is made to the corporate risk weight formula for exposures to SME borrowers. We compared the minimum capital requirement for the SMEs with that of the corporate, supposing the same PD-s and LGD-s, and we found, that the ratio of the two capital requirements is neither a constant, nor a monotonous decreasing function of PD, but a special shaped curve - represented in the chart. This curious phenomenon is explained by the chosen way of SME adjustment at the correlation. Because this phenomenon lacks of any theoretical background and reflects the weakness of calculation method of capital requirement, we propose the modification of firm-size adjustment manner.



* = 1 - capital requirement of SME's / capital requirement of corporates; LGD = 45%