A. GENERAL COMMENTS

(i) Recommendations made in the New Accord will no doubt encourage banks' risk assessment capabilities and therefore promote better risk management.

(ii) Basel II is designed to promote and reward enhanced internal risk management practices.

(iii) Appropriate and sufficient data to enable the transition to the advanced approaches for both credit and operational risk may be the key matters that require consideration in the adoption of Basel II and the development of the areas of national discretion.

(iv) Cost of implementing the accord

The cost of compliance to the New Accord will be for banks and supervisors, for example, where banks' existing systems do not exactly match the prescribed methods, material expenditure will have to be incurred to ensure compliance regardless of the effectiveness of the existing systems.

(v) Level Playing field

Some banks have commented that there is too much discretion left to local regulators. This may lead to circumstances whereby some national supervisors will be more conservative in the interpretation and application of the Accord while others will operate in a more lenient way.

(vi) Internationally active banks

Internationally active banks have both a home and a host supervisor, who may, because of the operation of national discretion, local legal obligations or simply different opinions require risks to be measured in different ways.

The home and host Supervisors may also both wish to review the same particular aspects of capital adequacy, increasing the possibilities for duplication with significant unwarranted cost and inefficiency for both banks and their supervisors.

Differences in implementation requirements for each national supervisor may lead to potential costs and complexity.

The local supervisor may not have the resources and expertise to adequately assess and validate the internal models of internationally active banks.

(vii) Complexity

The complexity of the New Accord may challenge the ability of supervisors and management to understand the factors driving reported capital adequacy and concentrate attention on the prescribed measurement of risk exposure instead of on risk management.

(viii) Prescriptive Detailed Rules

The prescription of the New Accord may lead to difficulties in reflecting the evolution of market practice or other improvements in risk management in the computed capital.

(ix) **Alignment with economic capita**l

Increased alignment between regulatory and economic capital measures can create real incentives for banks to improve their risk management systems and contribute to the development of more resilient financial systems.

(x) Pro-Cyclicality

The revised and 'flatter' risk-weight curve may not be sufficient to address the issue of minimum capital requirements affecting economic and business cycles.

B. COMMENTS SPECIFIC TO THE PILLARS

(i) Pillar 1: Minimum Capital requirements

a) Credit Risk Capital

The proposed approaches for credit risk presupposes the tracking of and availability of suitable data to support the ability to determine, model and back test internal assumptions. This area will need development and may require transitional support.

The approaches also require the use of external data to validate and augment the capital adequacy determination. The availability, appropriateness and confidentiality of data may be a significant challenge.

The Standardized Approach

The cost/benefit analysis of having recourse to external rating agencies must be assessed. Furthermore, the proposed 'Simplified Standardised Approach' would make the option very simple and inexpensive to adopt but would not be a great improvement from the current Accord and would penalize good clients.

The Foundation Internal Ratings Based Approach (IRB)

Substantial investment will be required in terms of systems and data collection and acquired skills to determine the Probability of Default. The Loss Given Default to be provided by the supervisory bodies will also depend on the availability of reliable historical data.

Moreover, there should be consistency in the approach across all banks for determining Probability of Default to avoid inconsistent ratings among customers banking with different institutions. Hence the supervisory body could provide guidance on methodologies that should be adhered to by all banks and play an active role in the collection and dissemination of industry data/information.

The Advanced Internal Rating Based Approach

This approach has similar limitations to the foundation IRB approach. Some banks have suggested that the central bank may consider imposing minimum standards before granting authorisation to adopt the approach.

b) Operational Risk Capital

The basic indicator and standardised approaches are simple to implement and will be a starting point for banks which have yet to set up operational risk assessment systems or which are in the process of setting up operational risk systems. Such risk cannot be modelled in the quantitative way proposed under Basel II rules. Indeed, operational risk capital is primarily to insure against the risk of being fundamentally surprised by a major event, but it is difficult to predict and measure the unexpected.

The proposed methods are not relevant to major risks, such as, frauds, changing legal environment and major disasters. The resources devoted by banks toward operational risk systems and loss databases could be better utilised elsewhere.

Given that banks will quantify operational risk, they may be under the impression that they have correctly measured and controlled the operational risk, which may not necessarily be the case.

The Standardised Approach

The calibration of business lines beta factors in the Standardised Approach for measuring Operational Risk for Corporate Finance, Trading and Sales, and Payment and Settlement at a level above the alpha factor in the Basic Indicator Approach might discourage banks to adopt the Standardized Approach

The Advanced Measurement Approach

The flexibility of this method is essential to accommodate the pace of development across the industry in Operational Risk Methodology and practice and banks welcome the recognition of insurance mitigation.

However, the lack of sufficient internal and external historical data will be the major roadblock to the adoption of the Advanced Measurement Approach. Additionally, banks feel that completeness of loss data will be supported by mapping to Regulatory loss data categories. Hence, the requirement to map loss data to regulatory business lines is considered to have no business use and no clear regulatory use.

(ii) Pillar II: Supervisory Review

- Skills, knowledge and guidance will be required to effectively develop national discretion matters and support adoption.

- **Credit-Risk "stress test"**

  This test will amount to an extra layer of buffer capital so that banks will not need to dig into their core capital in rough times: this proposal could easily negate the purpose of calculating risk-sensitive capital requirements under Pillar 1 as the total requirement would always reflect adverse circumstances regardless of current conditions. There would also be question as to what the minimum level the buffer should be allowed to fall when conditions do deteriorate, that is, how bad a slump should the buffer accommodate.

- Banks are concerned of the extent to which increased supervisory scrutiny will translate to interference in how they manage their business.

- Pillar II add-ons may be used to penalize banks, which, for good commercial reasons, choose to adopt the standardised approach.

- Pillar II reviews may 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 do not favour the adoption.

- Supervisory approval regarding the use of the Alternative Standardised Approach further adds on to the issue of level playing fields.

(iii) Pillar III: Market Discipline

Though banks do recognise the efforts made to achieve agreement with the industry, the detail and prescription in the Pillar III market disclosures continue to give cause for concern. Banks feel that the frequency of disclosure will have to consider the cost of regulation and resources. Furthermore, alignment with generally accepted accounting principles applicable in the jurisdiction and with regulatory reporting requirements may entail further costs.

C. CONCERNS/ SUGGESTIONS SPECIFIC TO MAURITIUS

Banks feel that the adoption of Basel II and the associated supervisory discretion can lead to an enhanced perception of the Mauritian banking industry and the supervisory process, however the following concerns/suggestions have been raised:

- Time frame for implementation as agreed by the G10 might not be appropriate for Mauritius.

- Central bank is expected to (i) define transitional period for the adoption of the New Accord, (ii) to set up forums for debate where experts would be invited to share their knowledge and views with the Mauritian banks to help a smoother implementation and (iii) partner with all banks in taking decisions with respect to implementation time frame and the extent of the application of the new framework.

- Banks have suggested that the possibility of adopting different approaches for different types of clients be considered. Indeed, the environment limitation in respect of certain clients would prevent the adoption of the IRB approaches.

- Given that the New Accord will incorporate operational risk, banks expect the capital adequacy ratio to be revised to 8% from the current regulatory requirement of 10%.

- External Credit Agencies are not available in Mauritius at present.

D. GENERAL SUGGESTIONS

- There should be an adjustment from the rigid and prescriptive risk measurement methodologies towards a more principles-based approach.

- The number of local regulatory discretions should be reduced.

- There should be standardised rules within different Pillar I calculation approach (e.g treat undrawn commitments the same in Standardised and IRB Foundation approaches)

- There should be an explicit acknowledgement that capital level may fluctuate and that Pillar II reviews and stress test not become ratchets that only increase regulatory capital requirements. Banks should be permitted to live within their plans when tough times arrive, and regulators should resist the temptation to continue to require the capital cushion to remain untouched.

- National regulators should ensure uniformity of interpretation of the proposals where national discretion is given.
- 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.
- A consistent and transparent application process for Pillar II should be preferred.
- It would be preferable and more consistent if the Committee articulated the principles which should drive recognition and valuation.

Pillar III

- An approach based on general principles with qualitative guidelines, and perhaps supplemented by worked examples is preferred compared to the current prescriptive rules. It is believed that such an approach will allow banks to provide disclosure more relevant to its own risk and will aid reporting of future developments in risk management practices.
- Closer links with the accounting standards setters should be further developed and encouraged.
- The differences between accounting disclosure rules, both current and proposed, and what is required under Pillar III need to be eliminated to avoid confusion for readers of accounts.
- In view of the extent and complexity of the disclosures, such disclosures could be made annually as part of the annual report as too frequent public disclosure is likely to consume resources and add costs, which will eventually be passed on to customers.
- Assess the cost benefit before deciding on the frequency of disclosures.

Operational Risk Capital

- Address operational risk through case-by-case supervisory reviews under Pillar II.
- Enforce the Basic Indicator Approach as a transitional approach.
- Operational risk mitigation products should be included regardless of the method chosen to compute the regulatory capital charge.

- More incentive to adopt the Standardised Approach as compared with the Basic Indicator Approach. In CP3, some lines of business have been assigned higher Beta factors than the 15% alpha factor used in the Basic Indicator Approach

- The final Accord wording should build in sufficient flexibility to allow for future enhancements to be incorporated within the Regulatory Capital framework, namely:

  - Correlation, which is rightly recognised by the Proposals. The guidance around correlation needs to leave the door open for a variety of techniques for estimating the degree of dependency between different operational risks.
  - The Soundness Standard, which still references a 99.9% confidence interval. In order to avoid future misinterpretation of this reference either its removal or greater explanation of its inclusion would be welcomed.

  - The proposals for the Advanced Measurement Approach should also allow the use of Alternative Risk Transfer methods as a risk mitigation technique provided certain standards are met.

  - Remove the requirement to map loss data to Regulatory Business Lines in the Advanced Measurement Approach.