Comments of the Reserve Bank of India on the Third Consultative Document of the New Basel Capital Accord

Introduction

The Reserve Bank of India (RBI) had forwarded its comments on the Second Consultative Paper (CP 2) of the New Basel Capital Accord to the Basel Committee on Banking Supervision (the Committee) in May 2001 and had also placed it on its website. RBI recognises that several of the concerns expressed and suggestions made by India and other emerging markets on the second consultative paper have been taken into account and addressed in the third Consultative Document (CP 3) after consultations and conducting a Quantitative Impact Study (QIS 3). Particularly, the provision of a Simplified Standardised Approach which provides for calculating risk-weighted assets, provision of preferential risk weights for retail exposures (75%) and residential mortgages (35%), aligning the capital requirements for credit risk in the trading book with the banking book and partial adoption of different approaches under the operational risk, reflect the Committee's endeavour in evolving a consensus which would facilitate adoption of the New Capital Accord in many jurisdictions.

2. However, some of the issues relevant in the context of the emerging markets and developing countries are yet to be fully addressed. In its attempt to strive for more accurate measure of risks in banks, the simplicity of the present Capital Accord is proposed to be replaced, with a highly complex methodology which needs the support of highly sophisticated MIS/ data processing capabilities. The complexity and sophistication essential for banks for implementing the New Capital Accord restricts its universal application in the emerging markets. Banks in these emerging markets form a significant segment in financial intermediation and are likely to find implementation of the New Capital Accord a major challenge in the medium term. Besides banks, supervisors would be required to invest considerable resources in upgrading technology systems, and human resources to meet the minimum standards. Banks in emerging markets would, therefore, face serious implementation challenges due to lack of adequate technical skills, under development of financial markets, structural rigidities and less robust legal system.

3. The QIS 3 results for the Standardised Approach show an increase in capital requirements for all country groupings in respect of both Group 1 and Group 2 banks. The QIS 3 results from the participating non-G-10 countries show that overall increase in risk weighted assets under the Standardised Approach was 19%, reflecting the impact of new operational risk charge (+ 15%) plus a credit risk contribution (+ 4%). These average contributions fall to + 11% and + 2% respectively (or an overall increase of around 13%) after some recalibration to the risk weights attached to claims on retail portfolios, residential property and past due loans.

4. The Reserve Bank of India is fully committed to implement the best international practices. However, the level of preparedness of the banking system and the supervisors would vary from country to country. In view of this, it will be desirable to assign greater flexibility to national supervisors to calibrate risk weights on different types of exposures under the Standardised Approach. For example, the CP 3 has recalibrated the risk weights on claims on retail portfolio to 75% and residential property to 35%. The CP 3 has also indicated reduction in risk weights on past due loans from 150% to 100% or 50%, depending on the level of provisions held against such loans and to encourage banks to make higher provisions for past due loans by providing capital relief. RBI welcomes such adaptability in the approach shown in CP 3. RBI also notes that the national supervisors can consider a higher risk weight on unrated claims on corporates if warranted in their jurisdictions. However, RBI feels that there are many other areas in which national supervisors can be allowed greater flexibility in assigning a lower risk weight if the country-specific situation so warrants than following a "one-size-fits-all" approach based on the external ratings under the Standardised Approach. RBI has examined the various aspects of the proposals contained in the CP 3 and specific comments thereon are detailed hereunder:

Scope of application (paragraph 1)

4.1 The Committee has proposed that the New Accord will be applied to internationally active banks. However, it has been indicated in the Overview of the New Basel Capital Accord that the New Accord may be extended to include other significant banks as national supervisors deem appropriate. RBI reiterates that the focus of the New Accord should be primarily on the internationally active banks. As the main objective of the New Accord is to ensure competitive equality and providing a reasonable degree of consistency in application, it is necessary that all supervisors, across the world should have a common definition of internationally active banks. Basel Committee may, therefore, define what constitute internationally active banks.

In this regard, RBI is of the view that all banks with cross-border business exceeding say 20% or 25% of their total business may be defined as internationally active banks.

Cross holding of capital (Paragraph 10)

4.2 RBI, while appreciating the Committee's proposal that reciprocal cross-holdings of bank capital artificially designed to inflate capital position of banks should be deducted, feels that cross-holdings of equity and other regulatory investments may be allowed in principle, but may also need to be moderated to preserve the integrity of the financial system and minimise the adverse effect of systemic risk and contagion.

RBI, therefore, reiterates the view that the Basel Committee may consider prescribing a material limit (10% of the total capital) up to which cross-holdings of capital and other regulatory investments could be permitted and any excess investments above the limit would be deducted from total capital.

Claims on sovereigns (Paragraph 29)

4.3 The Committee's proposal that the Export Credit Agencies (ECAs) qualify for recognition only if they publish their country risk scores and subscribe to the OECD agreed methodology is appreciated. However, the OECD methodology and ECAs' country risk classifications are still confidential.

RBI, therefore, reiterates that the ratings of only those ECAs should be eligible for use in assigning preferential risk weights which

- *disclose publicly their risk scores, rating process and procedure,*
- *subscribe to the publicly disclosed OECD methodology, and*
- *are recognised by national supervisors.*

Claims on banks

4.4 The flexibility to provide uniform risk weight i.e. one category less favourable than that assigned to claims on sovereign to all the banks (under first option) **(Paragraph 35)** militates the basic philosophy of aligning capital adequacy assessment more closely with the key elements of risk. The mere location may not necessarily be a good indicator of a bank's creditworthiness. This proposal provides competitive advantage to banks with weak financials by virtue of their having been incorporated in better-rated countries.

RBI, therefore, reiterates its earlier view that the risk weighting of banks should be de-linked from the credit rating of sovereigns in which they are incorporated. Instead, preferential risk weights should be assigned on the basis of their underlying strength and creditworthiness.

4.5 The proposal to assign preferential risk weight to short-term claims **(Paragraph 38)** may lead to arbitrage of regulatory capital through roll-overs, concentration of short-term borrowings and serious asset-liability mismatches, which could trigger systemic crisis and contagion in the domestic inter-bank market. It would also be very difficult to monitor and control the rollovers of short-term claims, given the high volume of transactions in the inter-bank market.

RBI, therefore, reiterates that preferential risk weights should not be linked to the maturity of the claims.

4.6 Banks are strongly regulated and supervised entities. Risks inherent in inter-bank exposures are not comparable to that of the corporates. There is, therefore, a need for a modified treatment for claims on banks. The Basel Committee has provided discretion to national supervisors in **paragraph 28** to assign a lower risk weight to the exposures to the sovereign of incorporation, denominated in domestic currency and funded in that currency. A similar flexibility should be provided in respect of claims on banks as well under option 2.

RBI, therefore, reiterates that on the lines of discretion provided in the case of claims on sovereigns, the national supervisors may be given discretion under option 2 to assign lower risk weight, to all claims on banks, which are *denominated in domestic currency and funded in that currency, subject to a floor of 20%.*

External credit assessments

4.7 The Committee has indicated that if banks are allowed to use unsolicited ratings in the same way as solicited ratings there may be the potential for ECAIs to use unsolicited ratings to put pressure on entities to obtain solicited ratings. Therefore the Committee has proposed that such behaviour, when identified, should cause supervisors to consider whether to continue recognising such ECAIs as eligible for capital adequacy purpose.

RBI feels that it would be very difficult for the supervisors to take a view as to whether the ECAIs are using unsolicited ratings to put pressure on entities to obtain solicited ratings. Supervisors are neither equipped nor competent to identify such behaviour of rating agencies.

4.8 RBI appreciates the Committee's efforts in evolving a range of risk-sensitive options for assessing capital for credit risk. However, the reliance on external credit assessment institutions (ECAIs) under the Standardised Approach for assigning preferential risk weights may not be a better option. First, the credibility of the rating agencies is at stake and there is no system of accountability for sharp deterioration in the credit quality of rated entities immediately after assigning a rating. Secondly, their access to information, especially in the absence of transparency and good corporate governance principles is severely restricted; whereas, banks are privy to customer information and are less exposed to customer-related informational asymmetry. Thirdly, the population of rated entities, even in the advanced countries, and especially in the emerging markets, which have exposure to the banking system, is very few in number. Fourthly, the use of external credit rating agencies in the regulatory process may act as a disincentive for the banks to improve their credit risk rating systems.

4.9 It is appreciated that the expanded role envisioned for IRB Approach provides positive incentives to banks in improving their credit risk management techniques. However, the adoption of the IRB Approach, even under the foundation approach, requires considerable investments in IT / human resources and rigorous supervisory oversights. Thus, most of the banks may not be able to adopt, even in advanced markets, the IRB foundation approach and would initially adopt Standardised Approach.

4.10 With a view to encouraging the banks using Standardised Approach, to move over to the IRB Approach at the earliest and also to equip them during the interregnum to adopt robust internal rating systems, they may be allowed to use the internal ratings for assigning preferential risk weights, on certain types of exposures, subject to compliance with the minimum standards prescribed by the Basel Committee for internal ratings under the IRB Approach.

4.11 This could be gradually extended to a larger portion of the banks' asset portfolio. This will encourage banks to refine their credit risk assessment and monitoring process, which would facilitate better management of their asset portfolio. This will also avoid the use of ECAIs in the regulatory process and reduce the burden of additional cost on this count. Besides, the scarce supervisory resources will be optimally utilised for validating the banks' internal rating systems rather than for approving ECAIs. This would also avoid conflict of jurisdiction over rating agencies.

RBI, therefore, feels that while the internationally active banks in emerging economies may be initially required to follow the Standardised Approach, they may be allowed to use the internal ratings for assigning preferential risk weights, on certain types of exposures, after validation of the internal rating systems by the national supervisors.

Internal rating based approach

4.12 RBI appreciates the Basel Committee's proposal to offer a range of options of increasing sophistication for providing explicit capital charge for credit risk. RBI recognises the inherent attractiveness of the IRB Approaches, which will result in better internal credit risk management. However, the minimum requirements stipulated even under the IRB foundation approach are difficult to be implemented, especially in the emerging markets. Most of the banks do not have robust rating systems and historical data on Probability of Default (PD), nor do the supervisory authorities maintain time series data for estimating Loss Given Default (LGD).

4.13 It is well recognised that the proposal to assign banking book exposures into six broad classes of exposures with different underlying credit risk characteristics - corporates, sovereigns, banks, retail, project finance and equity under IRB Approach would better discriminate the likely pattern of portfolio losses. However, a common framework for definition of these segments, without recognising the institutional framework, value of accounts or geographical spread, may pose severe implementation problems to banks in emerging markets.

RBI, therefore, re-iterates that national supervisors may have discretion and flexibility in defining the exposure classes, such as corporate, retail, sovereign and project finance.

Operational risk

4.14 In the context of increasing globalisation, enhanced use of technology, product innovations and growing complexity in operations, RBI agrees, in principle, with the Committee's proposal to assign explicit capital charge for operational risk. RBI also acknowledges that the range of approaches of increasing sophistication - Basic Indicator, Standardised and Advanced Measurement - would set the basic framework for estimating capital for operational risk. Given the sophistication and database required for Standardised and Advanced Measurement Approaches, most of the banks, especially those domiciled in emerging markets would be adopting the Basic Indicator Approach.

4.15 The Committee has proposed that at national discretion banks can use Alternative Standardised Approach (ASA) for calculating operational risk capital charges (**footnote 91, paragraph 615**). This would serve as an intermediate stage for banks which are migrating from the Basic Indicator Approach to the Standardised Approach. It is observed that under the ASA, the *beta* will be 15% for retail and commercial banking if they are aggregated and the banks unable to disaggregate their gross income into the other six business lines can aggregate the total gross income for these six business lines using a *beta* of 18%. This suggests adoption of a higher *beta* under the ASA as compared to the *beta* applicable to the Basic

Indicator Approach which is 15% and may not, therefore, effectively serve the intended purpose of serving as an intermediate stage for banks migrating from the Basic Indicator Approach to the Standardised Approach.

RBI, therefore, is of the opinion that the Committee may review the beta applicable to the various lines of business under the ASA, especially when the banks are not able to disaggregate their income for some of the lines of business and keep the effective capital charge under the ASA at a stage between that required under the Basic Indicator Approach and the Standardised Approach.

4.16 It has been proposed that, under the Alternative Standardised Approach the exposure indicator for ‘retail banking’ and ‘commercial banking’ business lines may be the ‘volume of advances multiplied by *m* (which is 0.035)’ instead of ‘gross income’. It is also proposed that loans and advances for the purpose would be taken gross of provisions. Since this measure is intended to serve as an alternative to the measurement of gross income of these two business lines, it would be in order to reckon the advances ‘net of non performing loans’ under the Alternative Standardised Approach.

RBI is of the view that the proposal to alternatively consider volume of advances (instead of gross income) would imply a substantial increase in capital charge for operational risk. Hence, RBI feels that the volume of performing advances may be considered under the Alternative Standardised Approach.

International lending to developing and emerging economies.

4.17 Under the CP 3, banks have the choice to adopt any one of the following methods for measuring credit risk:

- Standardised Approach (SA)
- Foundation Internal Ratings Based Approach (FIRB)
- Advanced Internal Ratings Based Approach (AIRB)

Under the SA, the risk weight for sovereign exposures would depend upon the rating assigned to such sovereign exposures by export credit agencies. Under the IRB (Internal Ratings Based) Approaches, the risk weight would depend upon the rating by the banks’ internal ratings model and is computed as a function of the following four factors – probability of default, loss given the default, exposure at default and maturity. While the risk weight for exposures with the lowest rating (Below B-) under the SA is 150%, the same is likely to theoretically go up to 1250% under the IRB Approaches. This clearly illustrates the extent to which the IRB Approaches are more risk sensitive than the Standardised Approach.

4.18 It is unlikely that a developing economy would receive the best of the ratings. It is also largely unlikely that an entity in a developing economy would attract a rating better than the sovereign rating of that economy. In the circumstances, a bank adopting the IRB Approach is likely to be more averse to exposures to developing economies both directly (to the sovereign) and indirectly (to entities in that economy). As has been brought out convincingly in the paper 'Basel II and Developing Countries: Diversification & Portfolio effects' by Stephany Griffith-Jones, Miguel Angel Segoviano and Stepphan Spratt – this aversion may translate into either avoidance of risk or appropriate pricing of the risk resulting in the following scenario[*]:

> W*idespread adoption of the IRB Approach by internationally active banks would lead to a significant increase in capital requirements for loans to lower rated borrowers. To the extent that the pricing and availability of international bank loans is influenced by the capital requirements that relate to them, this would imply a sharp increase in the cost and/or reduction in the quantity of international lending to developing and emerging economies. The expressed purpose of the Basle II norms is to better align regulatory capital with actual risk. Therefore, failure of the proposals to take account of the benefits of international diversification suggests that, risk has not been measured accurately. By excluding the possibility that banks' capital requirements should take account of portfolio and diversification effects, the proposals effectively impose an inaccurate measure of risk, at the portfolio level. The fact that the proposals under Basle II will not allow these diversification benefits to be taken into account, suggests that the regulatory capital associated with lending to developing countries will be higher than that which the banks would - and currently are - choosing to put aside on the basis of their own models.*

---

[*] Stephany Griffith-Jones, Miguel Angel Segoviano and Stepphan Spratt – Basel II and Developing Countries: Diversification & Portfolio effects.

The BCBS has modified the IRB formula to take account of variable asset correlation as related to Probability of default, and those relating to the SMEs. Under the proposed treatment, exposures to SMEs will be able to receive a lower capital requirement than exposures to larger firms. The reduction in the required amount of capital will be as high as twenty percent depending on the size of the borrower, and should result in an average reduction of approximately ten per cent across the entire set of SME borrowers in the IRB framework for corporate loans. Since the BCBS has recognised the impact that differential asset correlation can have on the portfolio level risk, there is a strong need that a similar modification is justified with respect to internationally diversified lending.

RBI is of the view that there is a strong case for revisiting the risk weights assigned to sovereign exposures when the exposures are aggregated as a portfolio which enjoy the benefits of diversification similar to the approach adopted for retail exposures.

Trading book issues

4.19 The Basel Committee has indicated that the changes made in the trading book are consistent with the changes in the banking book capital requirements under the Standardised Approach. However, the Committee's proposal to provide explicit capital charge on the basis of ratings is not consistent with the banking book capital requirements in respect 'other category' which attracts a uniform capital charge of 8% (risk weight of 100%) and does not compare with the risk weight of 150% being proposed for claims on sovereigns, banks and corporates that are rated below B-. Unless, the capital charge or risk weights are uniform both in the trading and banking books, the New Accord may lead to banks resorting to regulatory arbitrage.

RBI, therefore, reiterates that the capital charge for specific risk in the banking and trading books should be consistent to avoid regulatory arbitrages.

Market discipline – Third Pillar

4.20 RBI shares the Committee's view that market discipline can contribute to a safe and sound banking environment. RBI also shares the Committee's view that too much information could blur the key signals to the market and agrees with the proposal to make a clear distinction between core and supplementary disclosures. Further, the proposals to mandate frequent disclosures on information, subject to rapid time decay, would facilitate market participants in taking informed decisions.

5. **General issues**

Impact on Capital under Standardised Approach

5.1 The Committee's views are apparently based on the assumption that capital discharge would be available on assigning preferential risk weights to claims on sovereigns, banks and corporates, on the basis of external assessments and recognition of more collaterals under credit risk mitigation techniques.

5.2 However, RBI feels that the adoption of the New Accord would definitely enhance the minimum regulatory capital, especially for banks domiciled in emerging markets on account of the following:

(i) All claims on sovereign in India are currently assigned a uniform risk weight of 0%. The discretion to assign a lower risk weight would henceforth be available to claims on sovereign (or Central Bank) of incorporation, denominated in domestic currency and funded in that currency. Other sovereigns are required to be assigned risk weight in the range of 0% to 150% on the basis of external assessments;

(ii) Similarly, under the Current Accord, all claims on banks are assigned a uniform risk weight of 20%. The 20% risk weight would become the **floor** under the proposed accord. Since most of the banks are not rated they would have to be assigned a risk weight of 50%;

(iii) The population of rated corporates is very small and hence most of them would have to be assigned a risk weight of 100%. The benefit of lower risk weight of 20% and 50% would, therefore, be available only to very few corporates;

(iv) Past due loans, net of specific provisions, would have to assigned a risk weight of 150% if the specific provisions are less than 20% of the outstanding amount of the loan if it is not fully secured or 15% of the outstanding amount of the loan if it is fully secured;

(v) Claims on certain high-risk exposures viz. venture capital and private equity, at national discretion, are also required to be assigned a higher risk weight of 150%;

(vi) The deduction of significant investments in commercial entities; and

(vii) Explicit capital charge requirement for operational risk.

5.3 The benefit of credit risk mitigation techniques also may not be available as most of the banks in emerging markets are not in a position to comply with the preconditions stipulated by the Basel Committee. These apprehensions were confirmed by the findings of the QIS 3 conducted by the Committee.

The RBI therefore reiterates that unless suitably modified, the adoption of the New Accord in its present format would result in significant increase in the capital charge for banks, especially in emerging markets.

6. Conclusion

6.1 RBI welcomes the adaptability in approach shown in CP 3. RBI also notes that the national supervisors can consider a higher risk weight on unrated claims on corporates if warranted in their jurisdictions. However, RBI feels that there are many other areas in which national supervisors can be allowed greater flexibility in assigning a lower risk weight if the country-specific situation so warrants than following a "one-size-fits-all" approach based on the external ratings under the Standardised Approach.

6.2 The Committee's proposal to apply the New Accord to all 'internationally active banks' within the G-10 countries by end-2006 and permit a longer lead time for banks in the non-G-10 countries acknowledges the need for adopting a flexible approach in the implementation of the New Accord. As the main objective of the New Accord is to ensure competitive equality and providing a reasonable degree of consistency in application, it is necessary that all supervisors across the world should have a common definition of 'internationally active banks'. Hence, the Committee may evolve this definition.

6.3 The QIS 3 results show that even under the Standardised Approach, which is likely to be adopted by most of banks in the emerging economies, there are

- sizeable increases in credit risk charges for bank exposures as also for sovereign exposures
- the impact of lower risk weights for retail exposures was on average less than expected
- the increase in risk weight to 150% for past due loans was also significant.

In view of the above, it may be necessary to review the relevant provisions of CP 3 with respect to the Standardised Approach.

6.4 The proposal to allow banks to adopt an alternative exposure indicator for retail and commercial banking under the Alternative Standardised Approach for calculating operational risk capital charges should reckon only performing advances in these two business lines rather than the total portfolio of loans and advances, which would imply a substantial increase in capital charge for operational risk. The Committee may also like to review the beta factor proposed under the above approach where the banks are unable to disaggregate their gross income into the various business lines, with a view to incentivise banks to migrate from the Basic Indicator Approach to more advanced approaches for measuring operational risk.

6.5 RBI appreciates the Committee's efforts in evolving the New Accord containing proposals that are comprehensive in coverage. When implemented, these would go a long way in making the capital allocation more risk-sensitive and use of supervisory oversight with market discipline would reinforce the supervisory framework and ensure financial stability. However, the complexity and sophistication of the proposals restricts its universal application in emerging markets, where the banks continue to be the major segment in financial intermediation and would be facing considerable challenges in adopting all the proposals. Like the 1988 Capital Accord, the New Accord should also preserve the spirit of simplicity and flexibility to ensure universal applicability including emerging markets. The New Accord would involve shift in direct supervisory focus away to the implementation issues. Further, banks and the supervisors would be required to invest large resources in upgrading their technology and human resources to meet the minimum standards. The increasing reliance on external rating agencies in the regulatory process would undermine the initiatives of banks in enhancing their risk management policies and practices and internal control systems. The minimum standards set even for the IRB foundation approach are complex and beyond the reach of many banks.

****