Response To
The Basel Committee On Banking Supervision
Discussion Paper

“The New Basel Capital Accord”
(January 2001)

Although the new proposal is a major step forward compared to the 1988 Basel Accord, the major outlines of the proposal were evident in the documents that were published in 1999 and 2000. As a concrete proposal, this New Basel Capital Accord (Basel II) will for the first time recognize differences in the true economic risk exposure between banks that should be reflected by variations in their capital. As a result, banks that can prudently reduce their capital will applaud this change while those institutions that have a higher risk exposure will be required to set aside more capital and will likely find the new proposal difficult to implement.

We have previously commented in detail to the Basel Committee documents that preceded this New Capital Accord, specifically:

- “A New Capital Adequacy Framework” (June 1999)
- “Range of Practice in Banks’ Internal Ratings System” (January 2000)

We will, therefore, restrict our comments to the issues regarding the Internal Ratings Based (IRB) approach and the necessary data to support such an effort in the context of new methods that are available today that can utilize bank specific transaction data and internal ratings to determine the true economic capital.

We support with the overall thrust of the Basel II proposal. In particular, we applaud the explicit recognition for the use of the IRB approach for the more sophisticated institutions. This is a significant improvement over the current minimum Risk Based Capital (RBC) approach that tends to penalize conservative institutions while rewarding risk takers. The RBC approach also encouraged sophisticated banks to engage in risk arbitrage. But contrary to the some opinions, we do not believe that the new IRB approach as disadvantaging smaller institutions. We would, therefore, encourage smaller banks to adopt this IRB approach as it is within their reach of expertise and cost.

In the absence of a robust methodology to discern a capital charge from internal ratings some banks and supervisory authorities have suggested using mapped capital charges from publicly available data. While this mapping is an easy means of implementing the IRB approach, the disparity in the internal ratings between various institutions are a strong disincentive because it is patently unfair to apply the same capital charge to different ratings however carefully the ratings are calibrated. But sophisticated methods are available today that can derive capital charges based on internal ratings using the bank’s own internal data. But the resulting capital charges
from such internal data could therefore vary significantly from both the current RBC and the publicly mapped data. Therefore, during the transition phase of the Basel II implementation we agree that the current or a modified RBC approach should prevail. Beyond the transition period, banks should be required to hold a minimal level of capital. If, when fully implemented, the true calculated economic cost of risk using the IRB method is too high to be commensurately rewarded by pricing, banks could choose to lower their risk profile. The transparency that derives from computing such a capital charge using internal ratings and internal data will over time help even the playing field.

Though not always ideal, most banks use some form of credit rating in their underwriting process. But Basel II would require more differentiation between grades in order to preclude the clustering of risk. In our opinion, such an expansion of grades can only happen if it reflects their current practice or if it extends their current process. The linkage of the capital charge to an internal rating in such a context should appeal to even the smaller less sophisticated banks.

The lack of bank specific historical transaction data for each institution is the most significant obstacle in successfully implementing an IRB approach. But efforts to build an industry-wide loan database contradict the basic premise of the IRB approach. The use of the public credit ratings mapped capital charge is a response to this lack of data.

Finally, sophisticated models and methods exist today that can utilize internal bank specific data and internal credit ratings to compute portfolio level capital charges associated with each level of risk and portfolio dimension. These models are not just for the sophisticated global banks but are well within the reach of smaller institutions. Although the IRB proposal in Basel II focused on the large commercial loan portfolios these new models are equally valid and easily implemented to the retail portfolios of consumer loans.

Therefore, as we view the Basel II proposal, there are only two requirements for a wider acceptance and adoption of an appropriate portfolio credit risk management system. We would recommend that the regulators provide clear directives in both these areas.

First, banks should be required to risk rate all commercial loans and be required to maintain accurate ratings at all times. A regular (at least, annual for non problem loans) loan review process should ascertain accuracy of the risk ratings. For very large portfolios consisting of hundreds of thousands of loans consider some computerized approach. Access to cheap computing power and good commercially available software makes this economically feasible and well within the reach of most banks anywhere in the world. Most such software can be calibrated to reflect an individual bank’s underwriting standards.

Consumer loans should be initially scored as part of the underwriting process prior to booking loans. The initial consumer scores are easily available from various commercial sources while sophisticated banks could generate their own internal score cards. For existing loans, the current delinquency information of consumer loans captures all the necessary risk information that is an analog of the commercial loan risk rating.
Second, banks should be required to begin capturing and archiving monthly extracts of their transaction data, both commercial and retail. All the data necessary for computing the capital charge is currently available within the loan transaction systems at most banks. Since most transaction data are currently held in electronic format, this requirement is not onerous to accomplish. Such data should be stored in a standardized format so that supervisory agencies can also have electronic access to the data during the bank examination process. In the long term, the availability of such data will facilitate the introduction of credit risk management systems at banks at a future date.

A benefit to adopting the above recommendations is that, despite the differences in underwriting standards and internal risk ratings systems between banks, an appropriate risk modeling system will capture and reflect these differences for supervisors to recognize the relative risk between banks. This should considerably ease the supervisory burden while providing regulators with timely information.

Supervisory agencies will find the transparency and sensitivity of an appropriate system to be of crucial value in monitoring individual bank behavior and in gauging their experience over time. As banks worldwide adopt such a system the industry will experience a reduction in the otherwise inevitable volatility that usually accompany economic cycles.