Hungarian Financial Supervisory Authority
President

June 5th, 2001

Ms. Daniéle Nouy
Secretary General

Basel Committee on Banking Supervision
CH-4002 Basel
Switzerland

Dear Ms. Nouy,

The Hungarian Financial Supervisory Authority (HFSA) in co-operation with the National Bank of Hungary (NBH) studied with great interest the latest version of the New Basel Capital Accord proposal issued for comments by 31 May 2001. Compared to the previous consultative document significant changes were brought about in the new capital adequacy framework proposal of the Basel Committee on Banking Supervision. As you are aware of it, the Hungarian supervisory authority has already made a few comments and proposals on the basis of the former version. While repeating some of these remarks, we have put forward some new comments and proposals consulted with the NBH, taking the changes into consideration in order to contribute to the achievement of a more sophisticated and economically justified capital adequacy framework.

We would like to reaffirm that the HFSA fully agrees with two guiding principles of the proposal, that is to enhance competitive equality and not decrease it, and to maintain the overall level of capital in the global system.

We remain confident, that views of presently zone "A" country like Hungary, will be appropriately considered and taken into account by the Basel Committee when further elaborating the proposal.

The comments and proposals are as follows:

The scope of application

1. The HFSA agrees with the proposal of the Committee to **extend the Accord for the holding companies and not only bank-led groups**. At the same time, we also believe that the continuation of common thinking to make clear the methods how insurance institutions should be consolidated is desirable. This is necessary in order to regulate cross-sectoral activities properly and to avoid regulatory arbitrage since several common segments of the banking and insurance activities have emerged.

2. We find the further elaboration of guidelines related to **cross-border consolidation** essential to contribute to its implementation. From a practical point

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of view it would be necessary to prepare more detailed guidelines concerning consolidation methods for banking group members operating in different jurisdictions under different economic conditions, accounting and other regulations (e.g. parent company and its subsidiary or two subsidiaries of the same parent company in different countries). We think that the Accord should express more explicitly the responsibilities and the accountability both of group members and of the competent supervisory agencies. As the consolidation can exclusively be considered on a cross-border basis wherever several jurisdictions are involved, the related co-operation and information exchange issues should be specified more precisely.

3. When **calculating the capital adequacy on a solo basis**, we found it appropriate and easy to handle the methodology of deduction from the capital the specific types of investments (any investments in financial sector subsidiaries, minority-owned stakes in the financial sector and significant investments in non-financial sector subsidiaries), consequently we prefer it to its more complicated alternatives.

Sovereign risk

4. We maintain our former view that **in the standardised approach the risk weighting of sovereigns** represents a basic issue, and that the risk weights should reflect more properly the experienced average default-rates by rating categories. It is especially true concerning a group of OECD countries where the economic situation is permanently improving and which risk premia have significantly shrunk over the last few years on the financial markets. If the proposed changes in the Accord were accepted and introduced, it would have an immediate negative impact on these well performing countries, not falling under AAA, AA categories.

We consider the proposed **risk weights not to be differentiated enough and those for investment grade sovereigns to be too high.** In our view internationally active banks often have an internal rating system for sovereigns, especially for the countries of 'non-investment grade' by rating agency terms. The results of these internal ratings correlate to some extent with the ratings of the external credit rating agencies, since both are risk oriented. Therefore we do think that a more sophisticated standardised approach for the risk weights of the sovereigns should not be independent from the ratings of the external credit rating agencies, and the risk weights used in this approach will become a benchmark for the rating of these agencies as well. As far as actual risk-levels are concerned, the trigger point where effectively higher risk weights are justified on the basis of statistical data is to be found around the borderline between "investment" and "non-investment" grades.

Though a number of changes had came along, we are further concerned about **the negative impact of the proposal on the above-mentioned OECD countries. In the case of Hungary**, it is very important to emphasise that the country since 1995 shows permanent improvement in macroeconomic and structural terms, including the financial sector, like the prudent operation of the credit institutions, the quality of financial regulation and the supervisory methods. Public sector ownership in financial sector arrived to a substantially low level, less then 19% in banking sector. That substantial progress was acknowledged by the OECD, when some of the countries including Hungary were invited to join the Organisation in 1996 taking up all the obligations and commitments arising from the membership.

The OECD Economic Survey of 2000 on Hungary qualifies its banking sector as "...one of the healthiest in the region". The external credit rating agencies themselves have commended the results of this process in the course of their assessments. They gave favourable and improving rating to Hungary. Now, the possible effects of the new capital adequacy framework proposal seem to be quite unequitable. In spite of the strongly improving performance of the Hungarian economy and its sound macroeconomic fundamentals in place, its banks and companies may be penalised unintentionally as they are proposed to get a higher risk weight compared to the present one. That would mean worsening of its relative position on the international markets.

As a consequence of the use of external ratings in the sovereign risk weights, the weight of Hungary's sovereign debt denominated in foreign currency would increase from 0% to 20%. This implies that the required regulatory capital allocated to cover the credit exposure to a Hungarian debt instrument will increase from zero to 1,6% (20% X 8%). This increase in required capital (cost) would certainly result the increase of the risk premium on the Hungarian external borrowings merely due to the regulatory change and not because of the change effective risk factors, against the background of substantially improving economic stability and performance.

Even if national discretion is exercised to apply lower risk weight to banks' exposures (denominated in domestic currency = HUF) to the Hungarian sovereign (or central bank) debt and other national supervisory authorities permits their banks to apply the same (preferential) risk weight, its relevance for foreign banks is limited since those banks are also required to have liabilities denominated in local currency (HUF). Considering the impact of the proposed capital requirement on the spreads (incorporating the risk premium), according to international and our own estimations there will be an increase of 30 basis points for sovereign debts in the A- category, though **the probability of default of sovereign debts graded A or above –even on a five-year cumulative basis- is practically zero.** (See attachment)

In our opinion, the weights of categories should reflect the real, effective risk of the concerning sovereigns. Accordingly, we would like to recommend some conditions which would not distort the basic principles of the new standardized approach but take into account the rating and default history of the borrower. **The risk weighting for OECD sovereigns rated into stable investment categories (at least above BBB+) should remain at 0% in case of countries which:**

- **have been rated by eligible external rating agencies as investment grade for at least five years,**
- **have not been downgraded during the said period,**
- **have not been rescheduled their external obligations during the past ten years.**

Though the new proposal wishes to get rid of the rigidities of the 1988 Accord, with the present proposal it does not target appropriately the benefits of a really flexible system. The present risk weights are still contributing to a very rigid system.

5. Since there is no relevant transfer risk, we fully agree with the proposal related to **0 % risk weighting for exposures on sovereigns (central banks) denominated in domestic currency** if the funding on the liability side is also in that currency. However political risk still exists in this case.

6. The HFSA basically agrees with the separation of country specific risks from risks of the multinationals. However, we think that it would be reasonable **to maintain sovereign risk weighting as a minimum for that of banks and corporates** concerning debts denominated in foreign currency. We are concerned about the practical impacts of the proposed abolishment. We consider the withdrawal of this limit justifiable only if there is adequate legal regulation in force (i.e. concern-rules) to ensure that other legal entity outside the country concerned takes over the liabilities of a debtor, which resides in a country becoming insolvent for political reasons or foreign exchange restrictions. The regulation should ensure that the guarantee of the legal entity which assumes the obligation is explicit, enforceable and irrevocable.

Claims on public sector entities

7. Generally we share the opinion that **public sector entities** (local governments, public corporates etc.) should be treated similarly to banks. However, we believe that the risk weights of local public sector entities should be determined by national supervisory authorities on the basis of their own rules, depending on the legal status of the entities (taxation power, bankruptcy and winding-up regulation). And it raises the question whether it would be appropriate and feasible if other foreign supervisory authorities also should use these weights as minimum in order to avoid regulatory arbitrage. I.e. country B can not set higher valuation than the supervisory authority of the home country A, but supervisions have to allow the application of higher weighting. However this problem requires further considerations.

Claims on corporates

8. **Concerning the standardised approach, risk weights have to be increased in case of corporates seated in countries with high default rates.** In our view, considering that the classification of sovereigns must take into account this risk, the above mentioned proposal raises interpretation difficulties. If the Basel Committee deems such requirements necessary, we suggest that it should be defined more precisely that to what extent the increase of risk weights is proposed in case of certain default rates.

Credit risk

9. According to the proposal of the Accord, the **requirements for credit risk apply to both expected and unexpected losses.** We think that it would be justified to specify capital requirements only for unexpected losses, if a bank prudently creates the specific risk provision for expected losses, in order to avoid an unnecessary duplication. However, in case the competent supervisory authority detects deficiencies it should have the power to set additional capital requirements for expected losses as well.

The use of the measurement methodology based on contractual asset-value instead of book value could be an alternative solution, but we do not find it expedient because this method is not in line with the internal measurement practice of many banks.

Operational risk

10. The proposal related to the **measurement and management of operational risk** constitutes an important but unsettled part of the Accord. In respect of operational risks we consider that a more detailed business line breakdown may be necessary, and we suggest that the supervisory authorities should have the power to identify more separated units (e.g. safe custody, trade financing, project financing) and to specify more stringent requirements.

We agree with the criticism expressing that the operational risk may result in doubled consideration and twofold capital requirements for certain risks. We believe that this problem can be managed only by Pillar 2: only if a bank is able to verify that the underlying statistics of its internally measured capital requirement demonstrates reasonably the overestimation of the supervisory authority.

Internal rating based approach

11. In our view the **IRB approach** will be an alternative option used by banks in Hungary, especially among subsidiaries or branches of foreign banks in a few years, which will require more sophisticated supervisory practice.

12. According to the Accord, the **function elaborated** primarily **to create risk weights** for corporates has to be applied to sovereigns as well. As we think that the default risk of sovereigns has different characteristics (e.g. more stable probability of default) than that of corporates, we suggest that less steep function - with altering the appropriate parameters - should be used in case of sovereigns.

13. The **calculation of default probabilities** is not an unambiguous process as a result of the few relevant data. At the same time the proposal includes only a list of the three admissible methods without giving desirable details. We believe that among these methods the adoption of statistical models requires the highest level of expertise and has the highest risk of errors, so we consider it necessary that the Basel Committee should give a concrete example including the demonstration of and the recommendation to a model for the statistical calculation of default probabilities.

Supervisory review process

14. Although the HFSA basically agrees with the **approach of Pillar 2 of the Accord** on the supervisory review process, we find it important to indicate that implementation of that approach will need significant changes in the operational environment of the HFSA. The implementation demands stronger discretional power of the supervisory authorities in general and in some countries, including Hungary, it requires considerable modifications in the present legal background. Besides we are concerned for those responsibilities of management that may be deemed to be shifted on to the supervisors, and we would like to bring into focus that the implementation of Pillar 2 is a so fundamental change that supervisors should be backed internationally.

15. The HFSA fully agrees with the decision of the Committee **to treat interest rate risk in the banking book under Pillar 2**.

Market discipline

16. The **disclosure requirements** are relevant first of all for professional analysts and not for the public. The HFSA agrees with the significant expansion of disclosure requirements, all the more because it can support the activity of the supervisory authorities in those countries where the extension of these authorities' discretionary power has limits. In our opinion the proposals in connection with the structure, comparability and communication channels related to disclosure methods should be elaborated in perspective in order to avoid an information "over-killing" effect.

We hope that the HFSA's views will be considered appropriately in the course of elaborating the next version of the New Basel Capital Accord, and with these remarks we could contribute to the valuable work of the Committee.

Yours sincerely,

Dr. Károly Szász

Annex

Table 1. Sovereign "winners and losers" of the new risk weights of standardised approach of New Basel Capital Accord

	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Sovereigns						
OECD	0 % (0 %)					
Non OECD				100 % (100 %)		100 % (100 %)

No Change
Old weights in brackets.

S&P tables:*

Table 2. Sovereign vs. Corporate Ratings Default Rates (%)

	1 Year		*3-Year*		*5 Year*	
	Sovereign	Corporate	Sovereign	Corporate	Sovereign	Corporate
AAA	0,00	0,00	0,00	0,08	0,00	0,20
AA	0,00	0,02	0,00	0,09	0,00	0,23
A	0,00	0,04	0,00	0,18	0,00	0,47
BBB	0,00	0,2	1,69	0,76	5,88	1,73
BB	2,00	0,9	2,99	4,91	NA	8,81
B	2,44	5,02	5,00	14,77	NA	19,89

Table 3. Sovereign Foreign Currency Average One-Year Transition Rates (1975-2000)

	Rating at End of First Year (%)														
Initial Rating	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B+	B	B-
AAA	97,6	2,1	0,4	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00
A+	1,4	91,7	5,6	1,4	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00
AA	0,00	13,6	83,1	1,7	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00
AA-	0,00	0,00	13	73,9	4,4	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00
A+	0,00	0,00	0,00	13	69,6	17,4	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00
A	0,00	0,00	0,00	0,00	12,2	80,5	2,4	0,00	2,4	2,4	0,00	0,00	0,00	0,00	0,00	0,00
A-	*0,00*	*0,00*	*0,00*	*0,00*	*4,8*	*4,8*	*90,5*	*0,00*	*0,00*	*0,00*	*0,00*	*0,00*	*0,00*	*0,00*	*0,00*	*0,00*
BBB+	0,00	0,00	0,00	0,00	0,00	10	20	60	10	0,00	0,00	0,00	0,00	0,00	0,00	0,00
BBB	0,00	0,00	0,00	0,00	0,00	0,00	6,9	24,1	51,7	6,9	6,9	0,00	3,5	0,00	0,00	0,00
BBB-	0,00	0,00	0,00	0,00	0,00	0,00	0,00	1,9	15,4	78,9	3,9	0,00	0,00	0,00	0,00	0,00
BB+	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	2,6	13,2	73,7	7,9	0,00	0,00	0,00	0,00
BB	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	3,1	9,4	75	6,3	6,3	0,00	0,00
BB-	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	6,7	3,3	66,7	13,3	3,3	3,3
B+	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	4,6	4,6	13,6	59,1	13,6	0,00
B	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	33,3	66,7	0,00
B-	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	16,7	83,3

* In: Rise and Fall of Sovereign Ratings, S&P