Consultative document
Comments on "The New Basel Capital Accord"

May 31st, 2001
Shinkin Central Bank
Part : General remarks

The basic effects of the revision may be considered as being described in section 46 of the Overview of The New Basel Capital Accord ("the Committee desires neither to produce a net increase nor a net decrease - on average - in minimum regulatory capital, after accounting for operational risk").

This may be understood as the additional capital requirements needed after the implementation of operational risk regulations would be offset by the expected effect of revising the risk weight of credit risk.

However, the condition for the offset would be that credit exposure to "A" or above rated corporates has to reach a certain level. Financial cooperatives, whose credit exposure concentrates mainly on non-rated SME's and individuals, the expected level of reduction in minimum regulatory capital related to credit risk would become small, or even zero. The result would be that capital adequacy ratio would become even lower, considering the effects of implementing operational risk regulations.

When implementing the new accord, it would be desirable to consider the introduction of granularity adjustment, which is accepted under the internal rating-based approach (the effect of reducing risk by diversifying credit exposure is greater for financial cooperatives), in order to eliminate unfairness.

Part : Revision of minimum capital requirements related to credit risk

1. The standardised approach

(A) Introduction of granularity adjustment
Within the standardised approach, adjustment for the increasing or decreasing effects on credit risk, derived from the concentration or diversification of credit exposure, is not accepted. However, from a technical point of view, the same effects of adjustment may be achieved by using the standardised approach.

Therefore, it would be desirable to include a mechanism within the standardised approach that will consider the effects of the concentration and diversification of credit exposure.

(B) Risk weight on claims secured on commercial real estate
Within the standardised approach the risk weight of claims secured on residential property is 50% (The New Basel Capital Accord - section 37), and the risk weight of claims secured on commercial real estate is 100% (The New Basel Capital Accord - section 38).

Meanwhile, within the internal rating-based approach the effect of risk mitigation for commercial real estate and residential property is accepted as being the same (The New Basel Capital Accord - section 208 - 224). There is a lack of consistency.

Therefore, with regard to the standardised approach, the risk weight on claims secured on commercial real estate and on residential property should be considered the same, namely 50%.
2. The internal rating-based approach

(A) Definition of default
The definition of default may vary widely from country to country according to their conditions. It would appear to be more effective if the definition of default, or loss given default, within the standardised approach were to be determined by the domestic authorities in each country.

(B) Floor rule for incentives of implementing an internal rating-based approach
When implementing an internal rating-based approach, it is necessary to estimate the probability of default and loss given default in an appropriate manner. It is also necessary to consider the operational burden and system requirements that need to occur. However, the credit risk reduction effects in an internal-rating based approach are estimated as being "a reduction in risk-weighted assets of 2% to 3%" (Overview of The New Basel Capital Accord - section 48), considering the costs these effects are relatively low.
Furthermore, the floor rule attached to the advanced internal rating based approach "during these two years, capital requirements for credit risk resulting from the advanced treatment will be subject to a floor of 90% of the institution's capital risk requirements for credit risk that would result under the foundation approach" (The New Basel Capital Accord - section 162), lowers the incentive to implement such an approach.
As the Basel Committee's objective is to "ensure that the regulatory capital generated is sufficient to address underlying credit risks and to provide capital incentives relative to the standardised approach" (Overview of The New Basel Capital Accord - section 7), the limited effects of implementation, and the attached floor rule, seem to be contradicting the committee's philosophies and is unnecessary.

Part : The implementation of capital requirements related to operational risk

The introduction of a standard regulation on operational risk sounds logical, but it should be further examined as to whether it is effective to introduce a universal regulation. The details are not determined yet, but "it has been estimated that operational risk accounts for an average of 20% of economic capital" (Operational Risk - section 21). It is suggested to consider 20% of capital as capital requirements. Considering that the nature of operational risk differs from country to country, according to their size and industry, we question the introduction of a universal standard.
With regard to the regulation on operational risk, domestic authority should survey the conditions of their country and establish a standard that goes with the actual conditions. Operational risk should be regulated under the second pillar that is lead by domestic authorities in each country, and not within the first pillar on minimum capital requirement regulation.

Part : Bank book interest rate risk

The point that bank book interest rate risk will be placed under the supervision of domestic authorities within the second pillar, in order to consider the actual conditions in each country, instead of placing it within the minimum capital requirements, is very understandable and logical.
However, regarding our country, it is not desirable to introduce a universal regulation, but rather a regulation that suits the several types of financial institutions and the actual conditions of each industry.