31 May 2001

The Basel Committee on Banking Supervision
The Bank for International Settlements
CH-4002 Basel
Switzerland

Ladies and Gentlemen of the Committee:

In response to the request for comments on the Consultative Documents to the New Basel Capital Accord, the enclosed comments on The Standardized Approach to Credit Risk, are submitted for your consideration. This submission consists of two enclosures:

Encl (1) Substantive Comments
Encl (2) Grammatical/Language Matters

Respectfully,

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Professor, Economics and Finance
Encl (1)

THE STANDARDIZED APPROACH TO CREDIT RISK

SUBSTANTIVE COMMENTS

1. page 2, paragraph 11. "Claims on sovereigns....of the very highest quality". This statement is ambiguous and needs some clarification. At what point does a sovereign drop from "highest quality" to only "high quality"? It is suggested that some quantitative measure be established to relieve this uncertainty.

2. page 4, paragraph 17. In the absence of any discussion of the reasons why, one wonders why ECA risk scores of 4-6 are identically rated at100%. Assuming that there is a substantive difference between an ECA risk score of 4 and 6, for example, then it follows that the risk weights should recognize this difference. It is recommended that this block be changed to read as follows:

<table>
<thead>
<tr>
<th>ECA Risk Score</th>
<th>4</th>
<th>5</th>
<th>6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk weight</td>
<td>75%</td>
<td>100%</td>
<td>125%</td>
</tr>
</tbody>
</table>

This would provide a smooth continuum of all risk scores and their related weights.

3. page 5, paragraph 22, bullet 2. The term "significant" is ambiguous and should be clarified. The ambiguity occurs in three ways: (1) Does "significant proportion" mean the number of high quality sovereign shareholders, or rather to the percentage of their shareholdings to the total number of shares. One can conceive of a scenario in which the majority of shareholders are high quality sovereigns (however defined), but whose shareholdings are less than "significant". (2) Are "high quality sovereigns" the same as "highest quality sovereigns" referred to in paragraph 11, page 2? If not, are these "high quality" sovereigns of greater risk that "highest quality"? If so, does that impact the shareholder structure? (3) What does the Committee consider to be a "significant" number? Does the number need to vary from one MDB to another? If so, under what criteria should the variance be allowed?

4. page 6, paragraph 25. There are three issues which the Committee may wish to reconsider:
   A. Why would sovereigns and banks that are unrated be considered as lesser risks that those sovereigns/banks rated below B-. If the Committee wishes to cap risk weights
at 150%, then perhaps assessments below B- might carry a weight of 125% and unrated assessments carry a weight of 150%.

B. In rating banks, whose sovereigns' assessments range from BBB+ to B-, the same, the Committee appears to be putting both "investment grade" and "non-investment grade" institutions on the same level of risk weight. The Committee may wish to reconsider and assign banks, whose sovereign is rated BBB+ to BBB-, a risk weighting of 75%, with those banks whose sovereign falls below investment grade assigned a risk weighting of 100%. It appears that the Committee was implicitly following this investment grade/non-investment grade structure in paragraph 13, page 3, (as well as in footnote 2, page 3) in determining the risk weights for sovereigns. Further on, page 8, paragraph 33, makes a similar structure for corporates. It is recommended that a similar approach be followed here.

C. There seems to be an inconsistency between the two options of paragraphs 25 and 26. It appears that, depending on the source of risk weights, a bank would face dramatically different risk weights, starting at the highest levels of quality. This could lead to pressures on national supervisors to use a more lenient method than might be warranted. There also appears to be an additional inconsistency in that, under the option of paragraph 26, all banks are assigned risk weights at least as high as under the option of paragraph 25, with the exception of unrated banks, whose risk weighting is only one half of the paragraph 23 risk weight. The Committee may wish to revisit these weight distributions.

5. page 7/8, paragraphs 33/35/37. The same issue is raised here as in #4 above, wherein unrated corporates are assigned a risk weighting more favorable than to ratings below BB-. In keeping with the Committee's desire to cap weightings at 150%, perhaps a better allocation of weights would be to assign a weight of 125% to "Below BB-" assessments and a weighting of 150% to unrated assessments. While, in truth, an unrated entity may turn out, ex post, to be a very strong credit, it may also turn out to be very weak. The very nature of being unrated should give one pause to ask why. Since assessments are determined ex ante, the more prudent action would seem to assign ratings as suggested here, i.e.: unrated at 150% and less than BB-, 125%. To this end, I would respectfully disagree with paragraph 37, and recommend its deletion.
6. page 11, paragraph 58. The Committee has made an extremely valid and important point with this paragraph dealing with the independence of ECAIs. However, it is believed that the Committee needs to pursue the matter further with, perhaps, guidelines on the level of public ownership, capital structure and perhaps even the nature of the public owners. These actions should be taken to ensure that the greatest degree of transparency and independence of the ECAIs is maintained.

7. page 14, paragraph 71. It is recommended that the Committee revisit the issue of using available short term assessments when long term assessments are also available, regardless of the ranking of the two assessments. One can create a scenario whereby the short term assessment of an entity may be more favorable than the long term assessment. Equity would argue for using the assessment that matches the maturity of a credit. It is also suggested that, in making an assessment of a claim that does not rank pari passu or better, an assignment of "unrated" may, in fact result in a risk weight lower than the long term weight, based upon the proposal of paragraph 33 above.

8. page 33, paragraphs 192,193. The Committee may wish to consider including cancellation of credit cover in the event that the purchaser of the cover had obtained the cover fraudulently.

9. page 33/34, paragraph 195(a). It is recommended that an additional credit event be added to read as follows:

- a change in the credit worthiness rating of an obligor by a rating agency.

The Committee’s attention is invited to situations (exemplified by the purchase of RJR Reynolds by KKR or the recent drop in the fortunes of companies such as Lucent Technologies) in which subsequent economic/business events have changed the credit worthiness of an obligor. Such an event may well impact on any recognized credit derivatives that had been put in place prior to the event occurring. The Committee may well consider adding this possibility.

10. page 34, paragraph 195(b). The Committee should consider some quantification of the term "reliably". Perhaps some variation of the Value-at-Risk methodologies now used by commercial banks would provide a more definitive measure of "reliability".

11. General Comment. Ongoing research with which I am engaged with banks in the State of Connecticut suggests that there is a reluctance to engage in credit derivatives because that would involve the banks in observing FASB 133 (modified by FASB 138), dealing with the accounting for derivatives. There appears to be considerable uncertainty about the implementation of this accounting standard, resulting in banks not wishing to become engaged in the use of the risk management devices available under the Committee’s proposal.
Encl (2)

THE STANDARDISED APPROACH TO CREDIT RISK

GRAMMATICAL/LANGUAGE MATTERS

1. page 2, paragraph 10. It is believed that the wording should be "assessments by eligible ECAIs", rather than "assessments of eligible ECAIs". It is not the ECAI that is being assessed, but rather the sovereign.

2. page 3, paragraph 14. Recommend that the words "the bank's" be added between "sovereign of" and "incorporation". As presently worded, the sentence does not make sense as sovereigns are not incorporated.

3. page 6, paragraph 24. Recommend that the last four words of this paragraph be changed to read: "the sovereign of the bank's incorporation". Same reason as in #2 above.

4. page 6, paragraph 25. Recommend that the words "the bank's" be added between "sovereign of" and "incorporation". Same reason as in #2 above.

5. page 7, paragraph 26. Recommend that the words "the bank's" be added between "sovereign of" and "incorporation". Same reason as in #2 above.

6. page 7, paragraph 29. Recommend changing the term "weighing in" to "considering". Reason: the term "weighing in" is awkward English.

7. page 7, paragraph 30. Recommend the words "of incorporation" be added after the words "home country". Reason: clarity.

8. page 13, paragraph 69, bullet two. Recommend change the words "to the claim with an assessment" to read "to the claim with the assessment". Reason: The sentence is speaking to a specific assessment, rather to a generality.

9. page 14, paragraph 76. There seems to be a word/phrase missing after the words "to the reduction of" and "by".
10. page 17, paragraph 93. Recommend change the words "instruments and" to read "instruments from". Reason: One segregates "from" not "and".

11. page 33, paragraph 195(a), line 2. Suggest adding the word "the" between "to" and "reference". Reason: the word "reference" needs an article.