Comments

CONSULTIVE DOCUMENT "THE NEW BASEL CAPITAL ACCORD"

Superintendence of Banks of Chile

We share most of the comments which arose in the two last CPLG meetings, mainly referred to i) the difficulties for several countries in meeting the 2004 deadline, and the feeling that an additional transitional period would be desirable; ii) the difficulties in collecting the historical data for implementing the IRB approach; iii) the additional conditions which applied to external credit assessment institutions; iv) the possibility that each country calculates its own betas factor; and v) the need to establish a clear relationship between provisioning and loan classification vis-à-vis capital adequacy. Nevertheless, we would like to address the following issues:

- **Pro-cyclical Effects**

The new proposal stands for a more comprehensive approach to risk assessment, however, some aspects which have been traditionally associated to signs of weakness of the 1988 Accord still persist. We think that the system is still pro-cyclical. In fact, when the economic situation is good, the risk classification improves, there are less capital demands and credit increases. On the contrary, when the economies are suffering are going through a recession, the system demands higher levels of capital, and thus, restrain credit. The above, is due partly to the reclassification to a lower rating by external credit assessment institutions.

The debate over the pro-cyclical effects of capital regulation has overlooked the important role that bank loan provisions play in the overall minimum capital regulatory framework. Inadequate assessment of expected credit losses leads to under-provisioning and implies that capital has to absorb both expected and unexpected losses, aggravating the negative impact of minimum capital requirements during recessions.

Therefore, cyclical shortages of bank's capital may not only be due to the risk based regulation of bank capital, but most prominently to the lack of properly risk based regulation of banks' loan provisioning practices. In this sense, provisions do not reflect the real risk -because losses are recognized only after they have occurred- trigging in that way the procyclicality of bank's lending behavior. We think that this kind of shortcoming can be lessened by, for example, the French proposal on dynamic provisioning.

- **Provisioning and Loan Classification vis-à-vis Capital Adequacy**

The traditional approach followed by supervisors regarding the allocation of capital and provisions has been that regulatory capital should cope with the occurrence of unexpected losses, that is losses that are large but infrequent, and that loan loss reserves should, instead, cope with expected losses, that is losses which occur on average.

The generalized recognition that bank capital should provide a buffer to unexpected losses is in fact based on the implicit assumption that expected losses have already been absorbed by properly set loan provisions. When, instead, provisions are inadequate, expected losses will impact on bank's capital. Therefore, the lack of a coherent and internationally accepted regulation of loan loss provisions reduces the usefulness of minimum capital regulation.

The second Consultative package suggests that under the IRB approach capital requirements will be calibrated to cover both expected and unexpected losses. This represents an important change in the relationship between capital requirements and provisions. It's necessary, (therefore) to gain clarity on this aspect, given the fact that in the medium and long term an increasing number of banks would adopt the IRB approach.

- **External Credit Assessments**

The larger role which would be assigned to private credit ratings lead to the following questions:

a) What conditions would qualify rating firms as regards risk classifications which are valid for the purpose of capital requirement?
b) Who would verify the fulfilment of these conditions? The supervisors of each country? What procedures would be used to ensure that these conditions are homogeneous among different countries?
c) Credit ratings can have a pro-cyclical bias. How would this bias be countered ?

We believe that the Committee should give guidance and provide explicit criteria governing the use of external credit ratings.

- **Operational Risk**

The 20% of current minimum capital requirement for calibrating the operational risk capital charge was thought for banks belonging to G-10 countries. It would be helpful that the operational risk capital charge for emerging market economies is dealt with separately, due to the fact that its markets are less complex but its banks maybe more prone to operational failures.

The operational risk "add-on" will lead to an increase in capital requirements, given that the use of the standardized approach for credit risk will have a small impact in capital adequacy. For example, in Chile, a limited number of corporates will get a risk weight below 100%, and besides, the availability of external assessments is limited.

The use of standardized and of internal measurement approaches show both an important limitation. There is not historical data concerning the occurrence of operational risk. Therefore, the likelihood of getting data to support an internal model is almost zero, this situation is more evident in emerging banking systems.

Operational risk is much more difficult to measure compared with credit and market risk. As the Committee said, "there is a very wide dispersion of operational risk capital charges for individual banks above and below the assumed industry average of 20% of current minimum regulatory capital". In our opinion, this would suggest that the implementation of the operational risk capital charges could take more time than the rest of the new Accord.