



THE PROPOSED NEW CAPITAL ACCORD
KEY OUTSTANDING ISSUES IN THE WESTERN HEMISPHERE
ASSOCIATION OF SUPERVISORS OF BANKS OF THE AMERICAS

The Association of Supervisors of Banks of the Americas, ASBA, has very closely followed the evolutionary process of the proposal leading to a new international agreement in the regulation of capital adequacy.

The objective of designing a more risk sensitive framework and the broadening of the scope of the regulatory treatment of banking institutions' capital are regionally welcome as positive goals.

In connection with the evolution of the proposal, the third consultative paper represents not only a richer version, but also one that irons out a number of technical glitches prevalent in previous versions.

Despite this positive regional outlook of the concept embodied in the accord, there is a widespread sentiment in the region in the sense that the proposal raises numerous challenges for its proper implementation. This document intends to deal with some of the issues that the supervisory community in the Americas considers most relevant.

1. Prerequisites

As it was previously mentioned, the proposed New Capital Accord represents an improvement and a better way to more accurately match the capital of banking institutions to the risks they face. However, the implementation of the framework embodied in the proposal will require countries to have in place a series of regulatory and supervisory practices without which, it is not feasible to envisage a sound implementation of the new capital framework.

The scope of these preconditions can be considerable, ranging from sound corporate governance in banking organizations, the foundations of a disclosure regime and sound accounting practices that allow for meaningful valuation, just to name a few.

In the case of the Americas, a number of jurisdictions are in the process of adjusting and improving their regulatory regimes. Some of the countries are adjusting their capital adequacy framework in order to incorporate the provisions of the Market Risk Amendment.

In the specific case of Pillar 1, although the existence of credit rating organizations is not imperative (since the framework of the simplified standard approach provides an alternative in Appendix IX), their existence and usage can certainly provide for a smoother and sounder application of the new accord. Since credit rating organizations are not present in certain jurisdictions in the Americas, the Committee could (perhaps through the FSI) document some cases of successful development and acceptance of rating agencies, and the use of ratings in developing markets as a guide for those that would look forward to implement this in their own economies. The Committee could also provide detailed guidelines on criteria for accepting the outcomes of rating agencies.

Another important precondition for the more advanced approaches of Pillar 1 is the existence of a meaningful pool of data to build sensible internal models that would be viable under the IRB approaches. Perhaps some specific training could be developed by the Financial Stability Institute regarding data treatment (for instance, handling, pooling, and the verifying the quality of data, among other issues).

Although ASBA recognizes that the basis of a sound regulatory framework are laid out in the Core Principles for Effective Banking Supervision, ASBA members would certainly welcome additional guidance from the Basel Committee on transitional and precondition issues. This guidance could assist supervisors in aligning their supervisory priorities in order to design a sound step-by step action plan that would pave the way for the implementation of the proposed new accord at some point in the future.

2. Timeline

The Basel Committee has set out as a target to implement the Accord by the end of 2006. This schedule is in accordance with both the group of banks that the Committee has been focussing on, as well as the expected progress of the different working parties set up in order to carry out the ground work needed to make feasible the implementation of the new accord.

Regarding Non-G10 countries, it is clear that each individual jurisdiction should decide in its case the pace of adoption of the accord, taking into consideration the specific conditions of both its financial system and its regulatory framework.

In particular, in the case of the Americas and for those countries considering implementing the proposed accord, some members of our organization may stick to the broad G10

guideline, while others have expressed the likelihood of implementing the proposed accord at a later date. Some jurisdictions openly envisage full implementation on or after 2010.

Regardless of the specific date, the target for implementation is also directly related to the scope of application that a jurisdiction intends to give to the accord.

3. Scope of application

The proposal states that the new accord is intended to be applicable to internationally active as well as significant banks. This expectation leaves room for supervisory discretion, even within G10 countries. For instance, a Non-G10 supervisor may choose to apply the new accord to a domestic bank that may not be internationally active but that is systemically very significant. On the other hand, in some jurisdictions, some smaller banking institutions may have some international presence, but because of their size and systemic significance may not be targeted by the supervisor for implementation of the proposed accord.

In this light, some supervisors may choose to apply the accord only to a fraction of banks within the system. For instance, an ASBA member (which is also a Basle Committee member) intends to apply the accord to less than 0.5% of its banks. However, those banks represent two thirds of banking assets in the system.

The scope of application of the accord in each country will be directly influenced by the shape and characteristics of the financial system. In the case of the Americas, one can frequently find financial institutions headquartered overseas being important players side by side with local banks. This is particularly dramatic in the case of small open economies in the Americas that have based their economic growth strategies in the development of the financial sector. However, in all cases, this international presence will exert positive pressure on supervisors, since these banking institutions will most likely be vying to use the more advanced approaches of the proposed accord.

4. Cross Border Implications

As it was mentioned earlier, the widespread presence of international banking organizations in the hemisphere raises numerous and most relevant questions regarding the specific handling of items that have a cross-border implication. For example, it is most likely that large internationally active banks will be allowed in their home jurisdiction to use the advanced IRB approach. In this regard, we must acknowledge that the home supervisor has a most prominent role in allowing an internal bank to use certain approach. Although it might be desirable both for the bank and for the home supervisor to use, for example, the advanced IRB approach also in branches and subsidiaries doing business in the jurisdictions in the Americas, host supervisors can under no circumstance, be expected to provide blanket authorizations for the use of advanced IRB. There are several reasons for this:

- The host supervisor may not be fully prepared to supervise an institution using the IRB approach.
- The host supervisor may not wish to include advanced IRB as an option within its banking system.
- The internationally active bank may be using a model that produces meaningless results when applied to local banking conditions.

On the other hand, we may also face situations where banks in the home jurisdiction may be intentionally kept under the current capital accord, while their subsidiaries somewhere in the continent may be compelled to implement the proposed new capital accord (perhaps even the Standardized Approach to Credit Risk).

In light of the above, and with the purpose in mind of avoiding potential regulatory arbitrage or supervisory hurdles, ASBA recommends to its members to establish a close bilateral dialogue in order to discuss specific cases in detail. However, some specific comments or guidance from the Basel Committee in this regard would also certainly be welcome. This guidance could cover the specific advantages of establishing common ground in Areas of National Discretion and harmonizing supervisory perspectives, especially regarding models assessment.

5. Benchmarks for International Financial Institutions

The role of international financial institutions (specifically the World Bank and the International Monetary Fund) in promoting reform and improvement in financial systems around the world is widely recognized. Their strategy for assessing the financial system of a member jurisdiction has come to be epitomized in recent years by the Financial Sector Assessment Programs (FSAP), and in a smaller scale by the Reports on the Observance of Standards and Codes (ROSC).

Since capital adequacy regulation is one of the key aspects assessed during an FSAP or a ROSC, it would be important for countries in the region to be assured that the cornerstone of assessments of the capital adequacy regime will be Core Principle 6 of the Basel Committee's Core Principles for Effective Banking Supervision and not the proposed New Capital Accord.

We are aware that officers from these organizations may have expressed themselves in this sense informally. However, given the potential anxiety in the region, we feel that a more formal pronouncement would be appropriate.

6. International Financial Flows

Numerous jurisdictions in the Americas consider inward financial flows as a vital component of their economies. In this regard, there is a degree of concern across several jurisdictions in the sense that some elements in the proposed new accord (in particular the treatment of cross border credits) could become a factor inhibiting foreign inward flows into some jurisdictions. While this represents a concern *per se*, there is an additional source of concern in the sense that a small variation in the outlook published by a rating agency could translate exponentially and very quickly into a reduction of available cross-border funding.

Another source of potential concern is the fact that the treatment of cross-border credits under the new accord could inhibit the potential benefits of portfolio diversification. This may alter the business pattern of international banking organizations.

In this respect, numerous members in the region would welcome the comments of the Committee in this regard.

7. Supervisory Review and Market Discipline

The proposed new capital accord contains in its Pillars 2 and 3 an important and enriching treatment of two issues that are paramount for a supervisory system: the role of the supervisor and the disclosure regime.

Although the proposed new accord has been designed as a comprehensive framework, it must be recognized that some jurisdictions may find constructive to start focusing their supervisory frameworks around Pillars 2 and 3, especially because Pillar 1 may be trickier to implement due to its more quantitative approach.

In this regard, ASBA will seek to promote initiatives that foster the strengthening of the supervisory bodies as well as an enhanced disclosure regime.

Any advice from the Basel Committee in this regard would also be welcome, particularly regarding the strengthening of the supervisory regime and a detailed roadmap for improved disclosure.

8. Regional Organizations and their Pivotal Role

We consider that regional supervisory organizations such as ours can play a crucial role in the dissemination, training and implementation processes of the proposed accord. For instance, regional bodies tend to keep a close relationship with their membership and are able to more accurately assess potential problems across a region. They are also ideal partners for the Basel Committee in spreading understanding and in-depth knowledge about a wide range of complex issues in the proposal.

Additionally, the fact that some regional members may participate directly in a number of capital related initiatives at a global level, facilitates the dissemination of key concepts within the region of the Americas from a closer perspective.

9. Conclusions

The proposed New Capital Accord is one of the most significant regulatory proposals issued in recent years. Although it may certainly represent significant challenges and even raise some concerns, the Association views the proposal positively, since it will give supervisors an opportunity to rethink a considerable portion of their supervisory system in favor of more risk-oriented approaches.

The Association members would like to further work with the Basel Committee in order to develop additional implementation guidance and concepts that are necessary in order to ensure a smooth transition to a sounder supervisory regime as it has been described above.