BANCO DE MEXICO

GOBERNADOR

Mexico City, July 28, 2003

MS. DANIELE NOUY
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
Basel, Switzerland

In response to the Third Consultative Package on the Proposed New Basel Capital Accord, I would like to take this opportunity to acknowledge the Committee's efforts to consider many of the suggestion made to the original Basel II proposal. However, I consider that there are some issues that the Committee should still address. Please find attached a document that contains Banco de Mexico's comments.

Yours sincerely,

GUILLERMO ORTIZ

Banco de Mexico's comments on the Basel Committee's third consultative package entitled "The New Basel Capital Accord"

Scope of application: Investments in non-financial companies

Since the Second Consultative Package on the New Accord the Basel Committee incorporated a section called "Scope of Application" which included issues on consolidation and situations of double gearing concerning banks' investment in commercial entities.

We reiterate our comment that the proposed materiality levels by which a bank should deduct the excess of an investment in commercial entities is too generous. Furthermore, the third consultative paper goes in the opposite direction to our comment as it suggests that excess in significant investment has to be deducted 50% from Tier 1 and 50% from Tier 2 capital, instead of from Tier 1 exclusively.

We believe that such generous treatment allows excessive gearing, which can have several implications, such as undesired extensions of the safety nets, conflicts of interest, transfers of risk to banks, and transfers of profits from banks. We strongly proposed more stringent limits to significant investments in commercial entities as well as a more explicit definition of "significant investment".

Guidelines on Provisioning Rules

To measure credit risk in the standardized approach, we applaud the third consultative paper introduction of an specific treatment for past due loans based on provisioning levels. However, we reiterate our concern on the lack of guidance on provisioning rules and we suggest that the Committee should state standards for loan classification and provisioning.

Role of national supervisors

The Accord opens the possibility for excessive discretion for national supervisors. This could have the following consequences: limits responsibility to bank's Board of Director and management, giving incentives to an inadequate corporate governance; the budget required for supervisors training will be burdensome; national authorities will need specialized staff to accomplished the Accord's implementation and supervision; impede a level playing field among countries resulting in a non comparable framework.

Other comments

Bank subsidiaries of foreign banks might face difficulties complying simultaneously with both, the capital rules imposed to them by their parent banks and the capital rules imposed to them by their host country supervisors.

If all bank subsidiaries should follow the capitalization rules imposed to them by their parent banks, we could end up with two very similar banks established in the same country subject to different capital standards. These last comments are of paramount importance for countries with a large foreign bank presence.

New risk weights for mortgage and retail loans versus corporate loans could jeopardize bank credit for corporate firms, which not always enjoy access to non-bank sources of financing.

BANCO DE MEXICO

GOBERNADOR

México City, August 1st, 2003

Ms. Daniele Nouy
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
Basel, Switzerland

In response to the Third Consultative Package on the Proposed New Basel Capital Accord, please find attached additional comments and suggestions that we regard of particular importance for emerging countries.

Yours sincerely

Guillermo Ortiz

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Banco de México's additional comments on the Basel Committee's third consultative package entitled "The New Basel Capital Accord"

On the benefits of international diversification.

From the perspective of emerging economies, not including the benefits of international diversification in capital requirements determination could prove to be costly. As has been shown by Griffith-Jones, et al (2002)[1], there is a lower correlation between the financial and macroeconomic variables of emerging and developed economies than there is across the latter. We recommend that this fact should be incorporated in the capital determination model to avoid higher requirements that could reduce the capital flow from developed to emerging markets.

On the high confidence level for regulatory capital purposes.

The different approaches to determine capital requirements are based on parameters calibrated for a well diversified portfolio of G10 international banks. The high confidence levels used in the proposal, may affect banks in emerging markets in a disproportional manner because their loss distribution functions have longer and fatter tails. Adding to that the typically higher country risk of emerging markets, may translate into chronic bank capitalization shortages and hence, credit constraints. We strongly suggest a recalibration of the models that takes into consideration the peculiar aspects of emerging markets.

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[1] Griffith-Jones Stephany, Miguel Segoviano and Stephen Spratt (2002) "Basel II and Developing Countries: Diversification and Portfolio Effects". Institute of Development Studies, University of Sussex.

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Minimum Capital Requirements

We believe that policy should be developed concerning other assets to be deducted from a bank's capital, such as related party lending, deferred tax assets and other intangible assets.

Claims on sovereigns, banks and corporations

The third consultative package includes new credit risk buckets (35% and 75%) for mortgage and consumer loans as well as for small and medium size enterprises loans. These risk buckets apply to particular segments of exposures. However, the scales of weights for sovereigns, banks and corporates remains asymmetric. In order to smooth the impact of the transition between buckets, we reiterate our previous comment that more intermediate risk categories should be included.

Risk weights of claims secured by residential property

We strongly oppose the proposal of lowering the weights assigned to mortgage loans from 50% to 35%. Our experience tell us that the existence of residential property collateral does not reduce the risk inherent to such loans in a way implied by the risk weights suggested by the proposal. Even though, the third proposal contemplates that national supervisors can increase this risk weight to reflect a better risk measure, we believe that such policies will be against a level playing field among countries. We reiterate our previous suggestion to treat mortgage loans as loans subject to risk mitigation.

Operational risk

The basic indicator approach which applies a fixed percentage (15%) of average annual gross income over the last three years seems to be high, as some Mexican banks will required up to 20% more capital requirements. We could expect national supervisors encouraging Mexican banks to apply at least the standardised approach to lower unnecessary additional capital charges.

Role of national supervisors

The Accord opens the possibility for excessive discretion for national supervisors. This could have the following consequences: limits responsibility to bank's Board of Director and management, giving incentives to an inadequate corporate governance; the budget required for supervisors training will be burdensome; national authorities will need specialized staff to accomplished the Accord's implementation and supervision; impede a level playing field among countries resulting in a non comparable framework.

Other comments

Bank subsidiaries of foreign banks might face difficulties complying simultaneously with both, the capital rules imposed to them by their parent banks and the capital rules imposed to them by their host country supervisors.

If all bank subsidiaries should follow the capitalization rules imposed to them by their parent banks, we could end up with two very similar banks established in the same country subject to different capital standards. These last comments are of paramount importance for countries with a large foreign bank presence.

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