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20 August 2003

Madame Daniele Nuoy
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Dear Ms Nuoy,

The New Basel Capital Accord -
Third Consultative Paper (CP3)

We refer to the above matter and wish to extend our appreciation to the BIS for providing opportunity for global regulators and bankers to provide insight and feedback on the latest proposals on the New Capital Accord.

2. With the consultative document entering the final stage before its finalisation by the end of this year, Bank Negara Malaysia (BNM) welcomes the latest proposals accorded in CP3, which has taken into consideration some of the issues highjlighted by the emerging markets. Nevertheless, BNM is very much aware that the finalisation of the consultative document is just the beginning of a long process towards the implementation of Basel II. We look forward to receiving continuous guidance from the BCBS to ensure the successful implementation of the New Accord.

3. In view of the impending finalisation of the New accord, we attach herewith our comments on the latest proposals, which have also incorporated views from the banking institutions within our local jurisdiction. We hope that these comments will be useful to the committee in finalising the New Accord.

Warmest regards.

Yours sincerely,

(Nor Shamsiah Yunus)
Director
Bank Regulation Department

3/33/8
Attachment

Basel II – Third Consultative Paper (CP3)
Industry Comments

Item	Industry Comment
Standardised Approach (STD) 1. Treatment of Past Due Loans	In CP3, the risk weights for past due loans can now be adjusted downwards depending on the size of the specific provisioning made against the amount of loan outstanding. This allowance could potentially provide greater capital relief to institutions but as provisioning in our jurisdiction is accorded only on the unsecured amount, it is highly unlikely that any of the past due loans within an institution would be able to benefit from this new proposal. As such, consideration should be given towards providing the preferential risk weight based on the size of provisions made against unsecured loan amount instead of the outstanding amount, particularly, in the case of recognised collateral such as residential property.
2. Claims on banks	Under option 2 for the treatment of claims on banks, those banks with external rating between A+ and A- will be allocated a RW of 50%. This is considerably more than economically justified and more than would be implied under the IRB approach which gives an RW of around 30%. This discrepancy might not be of great significance if the majority of interbank participants use the IRB approach. However, due to the lack of historical data in this sector, many banks will be adopting the STD. The impact on the relative attractiveness of A-rated banks as compared to AAA-AA alternatives would then be dramatic and could cause significant change in market activity. It would be highly undesirable for such a shift to be triggered by a regulatory decision that is not supported by real differences in risk. Accordingly, it is suggested that a 30% RW should be applied to A-rated banks under option 2 of SA.

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3. Others	There are concerns that some aspects of the minimum requirements for eligibility under the IRB approach will result in banks being forced to bias their inputs away from the true mean and towards stressed estimates. While there may be a place for stress testing within a bank's overall risk management, using stressed inputs to a model calibrated on a non-stressed basis will result in overstated capital requirements. The inputs should represent a bank's best estimates of normal circumstances. An example of this is found in Para 430 where the use of a default weighted average for LGD is agreeable but there is no relevance for the inclusion of the requirement for ' the bank must use LGD estimates that are appropriate for an economic downturn. Both requirements are conceptually wrong and practically burdensome. As most defaults occur in periods of economic downturn, a bank's average recovery experience will automatically be weighted towards such periods and to require extreme worst-case calculations will make the calculations unreasonably conservative.

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Operational Risk 1. Transition between BIA and SA	Under the BIA, the alpha factor is set at 15, whilst under the SA the beta ranges from 12% to 18%. For certain business lines such as corporate finance, trading & sales and payment & settlement, banks may be required to set aside more regulatory capital when using the SA which may be going against the spirit of incentivising banks to move towards adopting more advanced approaches. The beta values should be reviewed to provide the right cost benefits to adopt the SA. Imposing more stringent requirements under the strategic alliance via-a-vis the BIA, institutions may not on a cost benefit basis find it worthwhile to adopt the SA.
2. Insurance as a risk mitigant	In CP3, insurance has been recognised as an operational risk mitigant but is only eligible for usage under the Advanced Measurement Approach (AMA). While the motive of this restriction may be to incentivise the banks to adopt the AMA, it does not appear justified as the effectiveness of the insurance hedge depends primarily on the insurer and the terms of the insurance contract rather than on the level of sophistication of the insured. As such, it is suggested that the usage of insurance to mitigate risk should be allowed under all approaches for operational risk. Further to this, the mitigating effects of a Business Continuity Plan (BCP) as a form of insurance should also be recognised in the form of a capital offset, which will provide incentives for banks to develop a sound BCP.
Other comments 1. General	The proposed accord is likely to affect emerging markets as Basel II is more geared towards G10 countries. This will put a lot of pressure on emerging market banks in trying to follow G10

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	banks. The extent of the disadvantage will be hard to ascertain but will be dependent on the composition of their loan portfolio as well as the nature of the markets they are in. To narrow the gap between emerging market banks and G10 banks, the emerging banks may resort to confine the acquisition of loans that give the most favourable capital charge thereby denying credit access to the rest and encourage clients not to get rated thereby undermining the Accord's goal to promote greater financial market transparency.