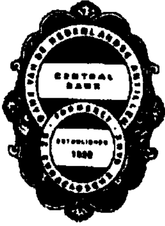

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August 1, 2003

The Basle Committee on Banking Supervision
Bank of International Settlements
CH-4002 Basle
Switzerland

Your ref.: -
Our ref.: UD/rcr/2003-10177
Re: Our comments on the third consultative paper on the new capital adequacy framework

Dear Sir or Madam:

Enclosed please find our comments on subject framework for your consideration. We hope our comments will contribute towards an improvement of the framework.

We would appreciate your reactions on the questions raised by us. If you have any comments, please do not hesitate to contact our Head of the Banking Examination department, Mr. U. Dalnoot at 5999-434 5620 or at e-mail address: u.dalnoot@centralbank.an.

Sincerely,
Bank van de Nederlandse Antillen

Dr. E.D. Tromp
President

Enclosed: Appendix with comments

# Appendix
# Comments on third consultative document of the New Capital Accord - April 2003

## A. Comment on the paper Pillar One – Minimum capital requirements

1. The current document is written in a complex way which makes effective, easy and smooth implementation more difficult. The final document will (have to) serve as a (reference) guide for both the supervisor as well as the banking institutions. In addition, supervisors will have to translate this document into draft rules, whereby we foresee that the input of external technical persons is needed. We will have to consult with the respective representative organizations on the draft. Therefore, it is felt that a more clearly written "client friendly" version of the document is required, sustained by further clarification through e.g. workshops/seminars, "helpdesks" or effective other means.

2. In our opinion, under Pillar I – claims on banks pg. 9 # 34 there is an inconsistency with #36. # 34 states that "no claim on an unrated bank may receive a risk weight less than that applied to claims on its sovereign of incorporation. However, #36 gives the option to give a non-rated bank a risk weight of 50%. Which is the correct method?

3. In our opinion, under Pillar I – claims on banks pg. 9 # 35, banks are being punished by giving them a weight one lower than that of the sovereign, while a bank's position and risk might be much better than that of a sovereign. Furthermore, a bank is under the direct supervision of the supervisor so why should the supervisor give a lower rating than that of the sovereign?

4. Under Pillar I pg. 11 Ref #45.
   In practice, residential property, built for renting, may be vacant for some time. E.g. because there is a time lap between the time the old tenants move out and the time that new tenants move in, or are contracted. Therefore, it is felt that the current proposal should allow for supervisory discretion to determine a vacancy time lap, possibly under added conditions, during which the 35% risk weight will still apply. #45 may read: "Lending fully secured by mortgages on residential property that is or will be occupied by the borrower, or that is or will be rented within a period of x months, will be risk weighted at 35%".

5. Under Pillar I pg. 12 Ref: paragraph 49. It is unclear if cars qualify as Risk Mitigator. If cars will be among the wider range of collateral which according to footnote # 23 may be recognized during a transitional period of three years as collateral, it is advised to allow that under national discretion whether or not to continue this after that period.

6. What will the treatment under Pillar I – claims on banks be for claims on banks in the same jurisdiction and in the local currency? We consider that supervisory discretion must be the answer to this question. Does the Committee agree?

7. Under pillar I pg 20 "overview of credit risk mitigation techniques" #98, it is stated that capital requirement will be applied to banks on either side of the collateralized transaction. It is not clear to us why the liability side is being charged with capital requirements.

8. With regard to Operational risk we want to comment as follows. Under the Basic indicator approach, it is required to calculate a flat capital charge of 15% of gross income as capital to be hold for operational risk. We do not consider this to be a prudent approach. By charging a flat percentage, the whole idea of creating incentives for banks that do their job is gone. We do not think that because the bank is not complex, it has to be punished.

   In the small jurisdictions as ours, the interest margin is very high. Therefore, the profitability of the banks taking only the gross income into account will seem high. However, in practice this profitability is much lower due to high operational costs. Therefore, and considering the historic high interest margins in our jurisdictions we do not consider gross income to be a good factor to determine the scale of activities of our banks. We think that also in this respect, the supervisors should be given the discretion to determine what percentage to apply. Hereby, the supervisors could have a system whereby, based on the classifications given to the individual banks by the supervisor through e.g. on-site examinations, a scale of percentages will be applied ranging from e.g. 5 – 15% of gross income. This will not only take into account our above mentioned concern but will also lead to incentives for small banks to have adequate controls in place. Once more we stress that the fact that a bank is small and non-complex does not mean that it is a threat. We have seen on numerous cases that it is the big companies, served by the big complex banks that fail. Small banks must also be allowed to obtain certain benefits if they have their controls in place. Furthermore, small banks are most of the times better controllable than big, complex banks since its activities can easily be overseen.

9. As to credit rating agencies, the use of IRB based approach and credit risk models we wish to comment as follows.

   Taking into consideration their sophistication relative to our as yet simple local economy, we consider the use of one of these approaches not to be cost efficient. Because one of those approaches can not be used, it will result (according to the table 1 in the consultative paper) in the application of the "unrated category" weightings of 50% - 100%. We do not consider this to be fair. Considering that it means that small simple economies will be punished while the risks may be far less than that of sophisticated institutions. In our opinion, this is also in contrast with one of the principles of the new Accord, being to make it suitable for countries beyond the G-10.

10. For small jurisdictions like ours, the IRB approaches will result in great challenges we may not able to meet without having to incur disproportionate costs. Correct use of the method sets high standards for the quality and quantity of data. Inference based on the normal distribution e.g. requires large data sets. Before banks could opt for this method they should prove they have an adequate data collection and registration organization.

    Therefore, we would want to propose to Basle and/or the (G-10) developed countries to assist the smaller jurisdictions by making technical assistance available to the smaller jurisdictions when reviewing banks that want to use the IRB approaches at no or low cost.

**B. Pillar Two: no comments at this time**

**C. Comment on the Pillar three - Market discipline**

1. Pillar three of the New Accord: Market Discipline promotes the Committee's feeling about the role the market can play in ensuring that banks hold adequate capital. The paper further indicates that the Committee aims to encourage market discipline by developing a set of disclosure requirements which allow the market participants to assess key pieces of information on the scope of application, capital, risk exposure, risk assessment processes and capital adequacy of the institution.

   We fully agree that it would be good if the market could understand abovementioned and can put pressure on the banks to hold adequate capital, especially with respect to the banks operating internationally. However, in small jurisdiction like ours, the (local) market does not play a major role as in developed markets such as in the USA and Europe.

   In our jurisdiction, the funding of the banks active on the domestic market comes primarily from the general public (savings and deposits), small institutions (deposits) and parent companies. On the other hand, the banks engage primarily in consumer and commercial lending and their investments are generally in securities quoted on the stock exchanges.

   Considering the above-mentioned, we wonder whether in our jurisdiction, market participants are able to, or interested in, studying the issues as detailed by the Committee and understand them fully to take an informed decision and also put pressure on the banks.

   In our jurisdiction, especially with regard to the institutions that engage primarily in domestic activities, the market is being determined by a small number of banks. The general public will focus primarily on the size of the banks and the facilities they offer along with the interest rates offered.

In this respect, it is good that the Committee expects that most of these disclosures are of particular interest for those institutions that rely on internal methodologies. However, it is for us unclear what the minimum expectations are for our types of jurisdictions (which also can not be compared with developing countries like some of the big Latin American countries). We are of the opinion that the market discipline paper is written from the perspective of the major markets.

In the smaller jurisdictions, the market does not function as well as and is not so developed and deep as in the major financial centers of the world. In our jurisdiction, the market is very limited and the question raised by a number of banks, which operate primarily locally, was: How should this paper be implemented in such a small jurisdiction like ours? In our opinion this is not clearly defined in the paper.

2. It might be useful to have an insight from the Committee as to how the host country supervisor should treat:
   - branches of institutions established in another country with regard to pillar one and three;
   - institutions that engage primarily in local activities with regard to pillar one and three;

   This in order to maintain some form of consistency in the regulations, taking into account the circumstances of the various types of institutions.

3. It is unclear to us why (as defined on page 159 Table 3 sub (b) of pillar three), the Committee requires the publication of the capital requirement for each category within the credit risk bucket. The essence behind it is unclear to us. We could understand the need to disclose this detail to the supervisor; however, the purpose of a public disclosure is not really clear to us, especially with regard to the domestic banks in a small jurisdiction like ours.

4. One issue for an international financial center like ours is the non-comparability between the member banks (local banks and international banks active on different markets). We wonder whether one standardized publication will do justice to this difference in types of banks.