BANCO CENTRAL DO BRASIL

DIRET-2003/3248

Brasília, July 31, 2003.

Mr. Jaime Caruana
Chairman
Basle Committee on Banking Supervision

Dear Sir,

Banco Central do Brasil congratulates the Basle Committee on Banking Supervision (BCBS) for its Third Consultative Document with the near-final proposal for the New Capital Accord. We believe the document advances both on the Second Consultative Document and the Third Quantitative Impact Study guidelines in several aspects, especially in regards to the treatment of retail and small and medium enterprises transactions and the recognition of specific provisions.

2. As in the current Capital Accord, the proposal is directed to internationally active banks in the BCBS countries, but it is expected to be applied to a wider range of countries and financial institutions. In that sense, the Banco Central do Brasil believes the flexible nature of the proposal will be fundamental in order to accommodate different legal and economic structures in various jurisdictions. In this respect, the New Accord should make clear that thresholds such as for defining small and medium enterprises and retail loans could be fine-tuned to reflect different economic environments.

3. It is important to note that the menu of options available to estimate more precise capital requirements and the differences in accounting and provisioning rules across different jurisdictions may endanger the comparability of capital requirements among institutions, as well as internationally. In this sense, in order to maintain the level playing field objective of the New Accord, we envisage that supervisors will need to establish disclosure procedures that can be more easily and efficiently collected and published, as well as guidelines to assure a smooth transition period for the full implementation of Pillar 3.

4. The Banco Central do Brasil regards as positive the fact that specific provisioning has been recognized in the scope of the standardized approach, at least in the treatment of past due loans. Nevertheless, we encourage further pursuit of internationally agreed provisioning standards, since inadequate provisioning hampers the effectiveness of capital adequacy regulation and jeopardizes international comparability. We understand that this is not quite within the reach of the New Accord, but the subject needs to be encompassed by the Committee's future projects. If the New Accord is to become as much a global regulatory benchmark as the 1988 Accord, it must be complemented by provisioning rules.

5. The complexity of the New Accord is an issue that cannot be minimized. The standardized approach will require that supervisors and regulators establish criteria that still need much discussion for accepting external rating agencies, whereas the validation process for use of the IRB approach will necessarily be quite resource-intensive. While the Banco Central do Brasil is dedicated to the construction of supervisory expertise, we are aware it may indeed prove to be a heavy burden to many countries, including our own. We look forward to increased international cooperation in training supervisors, building control and validation systems, and exchanging technology and information. The Banco Central do Brasil foresees the Financial Stability Institute playing a key role in that field.

6. Another area where increased international cooperation will be needed is the application of multiple systems for measuring capital requirements on a consolidated basis. The accuracy and sensibility of credit and operational risk measurements under the more advanced approaches will require the use of local default and loss data, representing additional compliance costs for subsidiaries which will need to run more than one system to fulfil eligibility criteria established by both home and host regulators. Coordination among supervisors may reduce the impact of such requirements, perhaps enabling regulatory information systems that can function cross-border. Consolidation procedures need to be refined and harmonized, especially

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between jurisdictions where the different components of a banking group may be located.

7. The Banco Central do Brasil restates its concern for the implicit incentive, within Pillar 1, for short-term claims. Much has been said about the intrinsic prociclicality of capital regulations, and we believe that, during the transition period of the application of the New Accord, the effects of such incentives should be properly assessed, as well as possible liquidity and operational risks involved in increased and generalized short-term exposures.

8. On the other hand, the Banco Central do Brasil welcomes the extension of a 20% credit conversion factor (CCF) for trade letters of credit, a claim from the Latin American Ad-hoc Group that the Banco Central do Brasil has strongly endorsed.

9. The securitization framework has shown advances along the lines of preventing capital arbitrage. Nonetheless, the effects of applying much higher capital charges or capital deduction for low quality/unrated tranches on securitization markets should be further evaluated during the transition period. Although these tranches may represent a higher risk, securitization is an effective instrument to assure healthier balance sheets, and it seems the proposed structure could make it more difficult for banks to remove higher risk assets from their balance sheets.

10. In regards to operational risk capital requirements, the Banco Central do Brasil realizes that since the Committee's proposal has been developed in order to obtain an average total capital requirement not inferior to the current level of capital for internationally active banks in the Committee's member countries, mostly applying the IRB credit risk approach, it may represent an actual capital surcharge on countries and banks applying the simpler approaches.

11. It is understandable that the basic indicator and the standardized approaches for operational risk produce a punitive measurement of operational risk for large internationally active banks – which are expected to have state-of-the-art

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operational control systems. However, smaller but well managed banks under the standardized credit risk approach are not, in the current proposal, eligible for the more advanced measures for operational risk. Only when they become eligible and validated for IRB would they be able to reduce their operational risk capital requirement. It is clear that there is a lack of continuity between the proposed approaches.

12. The scale and sophistication of transactions are factors that increase operational risk, as the Committee itself points out. However, these are not elements present in the business of small banks, and we see no reason why they should be subject to a high and roughly measured capital charge. Therefore, the Banco Central do Brasil expects that local regulator's discretion should be allowed in order to determine the appropriate capital level for smaller institutions under the standardized approach, based on local assessment of operational risk. This could be done by modifying the indicator, or simply by allowing the supervisory authority to require additional capital to cover operational risk on a case-by-case basis.

13. On Pillar 3, as stated in other opportunities, the Banco Central do Brasil strongly supports the use of disclosure to enhance market discipline. We welcome the improvements that have been introduced in the Pillar 3 structure since the Second Consultative Paper. We believe that the revised proposals will surely limit the burden associated with disclosure and restrict its focus to information directly related to risk management. The use of internationally agreed accounting and provisioning rules could make it easier to ensure that data is readily comparable and reliable.

14. The Banco Central do Brasil also sees Pillar 3 as an important complement to Pillar 2, to the extent that it is transparency that will permit the supervisors' role to be viewed as discretionary, and not arbitrary, in the establishment of capital levels, in the validation of internal credit risk classification systems and even in the certification of external rating agencies. The Committee is well aware of the qualification and perhaps legal problems that some jurisdictions may encounter in implementing Pillar 2, and in that sense the relevance of disclosure of supervisory procedures and criteria cannot be overemphasized.

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15. Finally, a few words on the evolution of the New Accord. One of the main responsibilities of regulators is counterbalancing market distortions without creating new ones. The transition period and the first years of implementation will be fundamental in identifying and dealing with unintended effects of the Accord. The effects on market developments, capital flows to emerging countries and consistency issues will need to be carefully assessed. The Banco Central do Brasil recognizes the Committee's efforts taken for ensuring that during the transition period the uneven introduction of the new capital adequacy structure does not create competitive distortions, and we see both the Committee's Capital Task Force and the Accord Implementation Group playing an important part in assuring that the New Capital Accord be as long lived and successful in promoting worldwide stability of financial systems as its predecessor.

Yours faithfully,

Paulo Sérgio Cavalheiro
Deputy Governor for Supervision