Santiago/Chile
July 2003

COMMENTS ON THE STANDARDIZED APPROACH OF THE NEW BASEL CAPITAL ACCORD (BASEL II)

Superintendence of Banks and Financial Institutions of Chile

A. Capital and provisions.

1. The standardized approach would gain clarity if it is explicitly stated that capital requirements seek to cover unexpected losses. This, on account that capital stands in a first stage both for expected and unexpected losses in the IRB approaches.

2. In the standardized approach exposures should be risk weighted net of specific provisions. The question arises as to why general provisions are not netted as well.

3. More risky assets require more provisions, but under the standardized approach these assets require at the same time more capital. It would be useful to say why this is so. Is there a presumption, based on empirically tested probability loss distributions, on account of which larger expected losses are correlated with larger unexpected losses?

B. Treatment of SMEs.

Exposures in small scale firms may be risk weighted at 75% under the standardized approach, provided such exposures meet certain condition. The loan loss experience of emerging countries as regards these exposures, suggests that their risks of loss are generally higher than that of corporate exposures. Therefore, Basel II would benefit from an indication which allows country supervisors to increase the above mentioned risk weight. The possibility of increasing a risk weight at national discretion is already envisaged in the case of claims secured by residential property.

C. Mitigating credit risk.

1. An important principle as regards credit risk mitigation is that its effect should not be double counted. This leads to the question as to whether collateral which reduces a credit exposure, and therefore provisions on such exposure, can be used to reduce the capital requirements on such exposure as well. It would appear, that an outcome of that principle is that if risk mitigants are used in provisioning, that they should not be used when determining capital requirements, and vice versa.

2. When assessing loan portfolio exposures and making provisions, banking practices in emerging countries rely on collaterals which are not mentioned for risk mitigation purposes in the standardized approach. Requirements of provisions and of capital could thus rely on different sets of collateral. This opens the question as to whether Basel II should indicate that eligible collateral should be the same both as regards provisions and capital.