Comments on the April 2003 Proposal of the New Capital Adequacy Framework

Standpoint of the Czech National Bank and the Czech Banking Association

Introduction

The Czech National Bank welcomes the efforts of the Basle Committee to enhance the regulatory and supervisory process and thus increase the stability of the banking sector by updating the existing techniques for measuring risk, introducing new techniques and by setting capital requirements to create a cushion against risk. We also appreciate that the national regulatory authorities from non-G10 countries have been given an opportunity to participate in the preparation of the New Accord.

We enclose a commentary on the proposed form of the New Accord as it was issued in April 2003. Some comments ask for a clarification of formulations or express our opinion that certain ideas or principles that seem to follow from the text should be mentioned explicitly, or some particular issues should be addressed. Others raise a request for a change aimed either at a principal issue or at a technical point. The individual chapters were discussed one by one with the Czech Banking Association. Many viewpoints of the Czech National Bank and the Czech Banking Association are in agreement. However, there are instances where the position of the Czech National Bank is different from the position of the banking community. In these cases the difference in opinion is always noted explicitly in the comment.

Organisation of the Commentary

An effort has been made to organise the comments in such a way that they would follow the arrangement of topics and issues in Consultative Paper 3.

In each chapter the comments are divided into two categories – conceptual and technical (in several instances there are only conceptual or only technical comments).

Scope of Application

<u>part A - conceptual comments</u>

1. Some G10 countries will retain their existing risk weighting treatment of insurance companies instead of deduction from capital (article 12). The position of the Czech National Bank is that on the one hand this approach will lead to competitive equality between banking and insurance groups within these countries, but on the other hand there will be ensuing competitive inequality among banking groups on the international level.

<u>part B - technical comments</u>

1. We recommend specifying the period after which capital shortfall must be deducted from the parent bank's capital (article 8). In our opinion, an appropriate period would be one year.

2. We recommend elaborating the diction of article 8 concerning third-party capital investments in subsidiaries that must be removed from the bank's balance sheet. We propose to replace the text "…will be removed from the bank's balance sheet" with the text "…will be removed from the consolidated bank's balance sheet for accounting purposes".

3. Where deductions of investments are made pursuant to article 18 the deductions will be 50% from Tier 1 and 50% from Tier 2. We suggest to state explicitly which course of action should be followed in case there is no Tier 2 (e.g. to include a footnote affirming that the deductions will be 100% from Tier 1 in case Tier 2 does not exist).

The Standardised Approach

<u>part A - conceptual comments</u>

1. Where a country's rating is lowered, the national regulator should possess the authority to set a transition period for the banks to adjust to the new conditions. A requirement for an extensive capital increase and the bank's inability to respond to it promptly may result in the necessity of severe regulatory action, even though the real change in the credit risk of the loan portfolio is not as sudden as the change in rating.

2. We are of the opinion that insurance companies should be given a different treatment, as these companies are regulated entities. However, this is our standpoint only under the assumption that the form of regulation is consistent with internationally recognised principles relevant to insurance companies.

3. The guidelines for the process of recognition of external credit assessment institutions (article 61) should be elaborated further to assume a more concrete and detailed form. This is essential for the regulators to be able to apply equal standards in the recognition process.

4. We propose to establish a procedure for recognising such ECAIs that do not have available data satisfying the structure laid down in Annex 2.

5. The calculation of cumulative default rates, as mentioned in article 7 of Annex 2, should be performed by ECAIs themselves (and national regulators should only assess the calculation).

6. In view of the fact that banks use IAS or US GAAP we recommend to include the treatment of gains and losses on an available-for-sale financial assets recognised directly in equity – according to IAS "revaluation reserve", according to US GAAP "other comprehensive income". Specifically, it is not obvious whether the gains and losses should impact Tier 1 or Tier 2 when calculating regulatory capital.

<u>part B - technical comments</u>

1. The circumstances under which supervisory authorities should increase the standard risk weights for unrated claims on corporates (article 41) should be described in detail (i.e. it should be stated clearly in which situations the risk profile of an unrated corporate claim becomes higher than normal).

2. The meaning of the adjective "short-term" in article 59 should be put in concrete terms.

3. We would like to point out at an inconsistency between the requests laid down by article 61 and those contained in Annex 2. According to article 61, an assessment methodology for each market segment, including rigorous backtesting, must have been established for at least one year before receiving regulatory recognition. According to Annex 2, cumulative default rates must be available over a three-year time horizon.

Credit Risk Mitigation

part A - conceptual comments

1. The list of eligible collateral in articles 116 and 117 does not mention insurance explicitly. The text that follows in CP3 does not state overtly whether insurance can be a recognisable credit risk mitigation technique in calculating credit risk regulatory capital under the standardised approach, possibly under which conditions this can be the case. We propose to clarify this issue in the text.

part B - technical comments

1. We recommend offering illustrative examples in order to be more specific about the period during which a bank should liquidate or take legal possession of collateral in case of a credit event. This concerns, for example, article 94, which states "" …legal mechanism by which collateral is pledged or transferred must ensure that the bank has the right to liquidate or take legal possession of it, in a timely manner…", and article 472, which states " "…collateral agreement and the legal process must be such that they provide for the bank to realise the collateral value within a reasonable timeframe…". The Czech Banking Association does not share this standpoint.

2. It is necessary to specify the concept "material positive correlation between the credit quality of the counterparty and the value of the collateral" (article 95) as well as the how frequently a bank should evaluate this correlation. In case this general condition of eligibility is related to both financial collateral and credit protection (guarantees and credit derivatives) it is necessary to state this fact explicitly.

3. The insufficient characterisation of the concept "material positive correlation between the credit quality of the counterparty and the value of the collateral " leads to a possible contradiction between the requirements of article 95 and article 165. The range of eligible guarantors/protection providers set out in article 165 includes credit protection provided by parent, subsidiary and affiliate companies of the obligor. Our opinion is that if a parent, subsidiary or affiliate company of the obligor provides credit protection there is a close relationship between the credit quality of the counterparty and the protection. Does this relationship fall into the category of material positive correlation?

4. We assume that the notion "market price volatility" in article 125 includes both the volatility of the exposure and the volatility of the collateral. In other words, article 125 and consequent articles stipulate conditions under which banks can calculate internally not only the values of Hc and Hfx, but also the value of He. If this is the intended meaning, it should be stated explicitly.

5. It is not entirely clear from the phrasing of the section on the use of VaR models (articles 149 – 152) whether the class of models that are eligible in this situation includes historical simulation models. We assume from the overall context that historical simulation models are eligible, but on the other hand the text of article 149 mentions price volatility, which is a kind of parameter that models in this category do not calculate. It would be suitable to clarify this issue.

6. We assume that the intended meaning of article 151 is the following. The VaR figure is calculated for a subportfolio composed of a long position in a credit exposure to a counterparty and a short position in collateral received from the counterparty and this is compared with the actual change in the value of the subportfolio. This type of calculation is subsequently performed with respect to each of the 20 counterparties. We deem it suitable to modify the wording of article 151 in order that its meaning will become more transparent.

7. Article 161 (c) states that, in order for a guarantee to be recognised, all types of payments the underlying obligor is expected to make under the documentation governing the transaction, e.g. notional amount, margin payments etc., have to be covered. We would like to be sure, as proportional cover is eligible according to article 168, that guarantees where the amount guaranteed is less than the credit amount and is explicitly stated in the text of the guarantee, do qualify for recognition and comply with article (c), even if the amount guaranteed is not defined on a pro rata basis but as a concrete amount (and, implicitly, e.g. interest payments may not be covered as even the principal exceeds the amount guaranteed).

The Internal Ratings-Based Approach

part A - conceptual comments

1. Based on our preliminary assessment, implementation of the IRB approach might not be achievable for all exposure types (e.g. due to a lack of data). Therefore we propose to adopt a principle that in justified cases the national regulator can approve concurrent use of the IRB and the standardised approach on a permanent basis.

2. We propose to exclude part "d" from the definition of qualifying revolving retail exposures (article 202). We are of the opinion that this part is not well specified and its exclusion would simplify the definition (if part "d" is left out, it will be necessary to adjust part "e"). The first weakness of the definition of qualifying revolving retail exposures is the ambiguous definition of FMI (future margin income) that can lead to different interpretations. The second and more serious weakness of the definition is the inconsistency in summation of expected losses and two standard deviations of the annualised loss rate on the sub-portfolio. If summing an expected loss (annual is assumed) and a standard deviation is to be consistent, the standard deviation must be defined as the standard deviation of annual loss rather than annualised loss rate on the sub-portfolio. We deem it is necessary to argue that the validity of the derivation of the level of FMI as a sum of expected loss and two standard deviations is likely to be unfounded. The mean value and the standard deviation have sufficient information capability in the case of symmetrical distributions like the normal distribution. Probability distributions of credit losses are strongly non-symmetrical and these two characteristics do not illustrate sufficiently these distributions. A more correct alternative could be, for example, to demand for FMI to be greater than or equal to credit VaR on the 95% confidence level. However, such a measure would fall outside the framework of the NBCA and therefore it would be more suitable to exclude part d.

3. We would welcome if the Basle Committee could explain (e.g. by publishing methodological documents on its web site) the background of the formulae in article 241 in order to make clear the underlying economic essence and the way the formulae have been obtained. We encourage the Basle Committee to do the same in the case of the "supervisory formula" in the chapter on securitisation and wherever the text uses a mathematical formula such that its justification and economic essence may not be simply obvious.

4. The Czech National Bank suggests including stress tests among the requirements on reporting in article 402. The Czech Banking Association does not share this standpoint.

5. The list of indicators of default in article 415 includes a situation, where a bank sells a credit obligation at a material credit-related economic loss (3rd indent). While the loss resulting from sale of non-negotiable products (e.g. loans) is usually fully attributable to credit risk, the loss resulting from sale of tradable products (e.g. bonds) is typically caused by a variety of factors (credit-, interest rate- and foreign exchange risk). As it is very difficult to distinguish these factors in practice, we propose to entrust the national regulator with the discretion not to apply this definition of default to selected products. Alternatively, the regulator could introduce a loss ceiling, only a break of which would indicate a presence of credit risk. The ceiling would be either defined by the regulator

itself or it could be based on the regulation of market risk capital requirements from which it can be implicitly concluded that price moves up to 20 per cent can be attributed to general and idiosyncratic risk.

6. We recommend altering the article 484 (recognition of other physical collateral). The burden of proving that the collateral meets the required standards will be up to the bank and the regulator will only assess the practice of the bank.

7. We suggest that the Basle Committee specify the form of recognition of credit risk mitigation in conjunction with specialised lending. Could a credit exposure that is fully guaranteed by an entity that does not satisfy the definition of specialised lending be regarded as a credit exposure to this entity?

part B - technical comments

1. We recommend defining the concept of purchased receivables (article 208). Otherwise the distinction between purchased receivables and other types of credit exposure (e.g. securitisation) may not be clear.

2. The general concepts "not in complete compliance" and "timely return" contained in the minimum requirements for the use of the IRB approach should be specified (e.g. a recommendation in the form of a footnote could be added). The Czech Banking Association does not share this standpoint.

3. We recommend explaining further the relationship between articles 409 and 424. Are the techniques for the estimation of PD in article 424 alternatives in relation to article 409?

Provisioning

part A - conceptual comments

1. We would like to point out that the concept "general loan loss provisions" is not in agreement with internationally accepted accounting standards (IFRS, US GAAP).

part B - technical comments

1. If the concepts "capital requirement" and "capital charge" used in CP3 are meant to be interchangeable synonyms (e.g. in articles 21 and 346) we deem it suitable to mention this fact at the moment of the first usage, for example in the form of a footnote.

2. We do not deem it suitable to use the term "capital requirement" to represent a measure in absolute terms in one case (article 21) and a measure in percentage terms in another case (article 241). For this reason we propose to use an alternative term in case this measure is understood in percentage terms.

3. If the term "portfolio-specific general provisions" denotes provisions established in those cases that impairment in assets is measured and recognised on a portfolio basis we recommend to leave out the word "general" in conjunction with this type of provisions (articles 342-347). If other types of impairment in assets are meant as well, we recommend spelling out the instances when general provisions (1st sentence of article 342) are to be established.

4. The text of CP3 does not illustrate clearly the treatment of provisions to equity instruments in the banking book that are not valued at fair value. We deem it suitable to clarify whether it is possible under the IRB approach to make use of provisions to those equity instruments that are valued not at fair value, but at cost and possible provisions are made (e.g. investments not deducted from capital). If these provisions cannot be made use of, especially with respect to the terms of article 343 -"For all equity exposures, the EL portion of risk weighted assets is defined as zero", we propose to mention this principle explicitly in part G.

5. We demand that a definition of the concept "expected loss capital charge" be added and furthermore, we suggest to clarify the relationship among the concepts "expected loss capital charge" (e.g. used in article 345), "capital charge" (e.g. used in article 346) and "expected loss portion of risk-weighted assets" (e.g. used in article 342).

6. It is not clear whether specific provisions to non-defaulting assets that exceed the EL capital charge for underlying exposures may be used to cover the EL capital charge to other non-defaulting assets in the same class. If this is the case it should be stated explicitly in the text. Article 346 and footnote 76 can be, under the current phrasing, interpreted opposingly.

Securitisation

part A - conceptual comments

1. In view of the fact that the new proposal of IAS 39 addresses the issue of securitisation, namely the recognition of risk transference, it should be assured that there be no incompatibility between the capital adequacy regulations and the accounting framework.

2. The exclusion of those credit assessments that are only made available to domestic and foreign institutions with legitimate interests (article 525 b) will be to a disadvantage of synthetic securitisation especially (in the case of credit default swaps ratings are typically available only to the counterparties in the trade). In addition, this rule is not applied in other areas of the NBCA.

3. The Czech National Bank deems it suitable that the Basle Committee explain (for example, by publishing a supporting document on the internet) the derivation of the supervisory formula (article 590) in order that the underlying economic essence will be clearer.

part B - technical comments

1. The Consultative Paper 3 does not characterise fully the position upon which the calculation of the capital requirement is based (we assume that it is the current book value).

2. The text that covers the supervisory formula fails to mention the meaning of the omega parameter.

Operational Risk

part A - conceptual comments

1. The Czech Banking Association recommends that the qualifying criteria for the Standardised Approach be abandoned. The Czech National Bank does not share this standpoint.

2. We recommend permitting a combination of the Basic Indicator Approach/the Standardised Approach and the Advanced Measurement Approaches with no time constraint.

3. The Czech Banking Association is of the opinion that the possibility to recognise the risk mitigating impact of insurance should be extended to the Basic Indicator Approach/the Standardised Approach. The Czech National Bank does not share this opinion.

4. We advocate the required use of the 99.9 percent confidence interval in the AMA to be reconsidered (article 627), because it is not generally feasible to obtain adequately accurate entry data (we propose as a more plausible approach for further consideration to use the 99 percent confidence interval and a multiplication factor).

5. We propose to reconsider the requirement of setting correlations among combinations of business lines and risk types equal to one unless a bank proves otherwise (article 629). There exist couples of categories where there is obviously no correlation (e.g. natural disasters and terrorist attacks), but it is not possible to present a rigorous mathematical proof of such a statement.

6. We propose to establish a permanent working group for operational risk alongside the Basle Committee.

part B - technical comments

1. In view of the fact that the Basle Committee has abandoned the requirement to follow the established definitions of business lines in the AMA, we propose to change the term "business line" in relevant parts of the text to such a term that would obviously imply a part of a bank's own organisation structure (this is the case, for example, of article 626 part b).

2. We recommend spelling out in more concrete terms those conditions under which the minimum regulatory capital requirement can be based on unexpected loss alone (article 629 part b).

Trading Book Issues

part B - technical comments

1. The Czech National Bank recommends reconsidering the requirement for compulsory use of the more prudent side of bid/offer (article 652) and suggests that the use of the mid rate be also allowed for those banks which are not market makers.

2. Article 653 stipulates requirements for the use of a valuation model where marking to market is not possible. The Czech National Bank raises an objection to the requirement of holding a secure copy of the model (5^{th} indent from the top). The requirement is excessive with respect to the costs and technical problems associated with holding an extra model and, furthermore, it is inconsistent in the sense that it is not extended to other IT systems in banks.

3. We suggest that the notion "unearned credit spread" used in article 657 be specified in more detail.

4. We suggest being very specific regarding the demand that operational risk be considered when making valuation adjustments. As valuation adjustments must impact regulatory capital, making this request in a general case leads to a duplicate capital penalisation of a bank (in view of the fact that a capital requirement for operational risk is being introduced).

5. In the case of less liquid positions we regard making valuation adjustments as a more correct approach than establishing reserves (article 658).

6. While the first sentence in article 663 is related to repo-style transactions only, it is not obvious whether the next sentence that deals with the application of the firm size adjustment for SME's governs repo-style transactions only, too. In our opinion, the firm size adjustment for SME's in the trading book should be applied to all trading book instruments, not just repo-style transactions.

7. It is essential to make clear whether credit derivatives booked in the trading book that qualify for a reduction in the capital requirement for banking book exposures pursuant to article 664 are also subject to capital charges for general market risk and specific risk. In other words, it is not obvious whether the capital treatment outlined in the third sentence of article 664 is meant to include this category of credit derivatives.

8. The meaning of the text marked with a double asterisk in article 675 is not entirely clear. Therefore we recommend its further clarification.

Pillar 2

part A - conceptual comments

1. The Czech Banking Association is aware of the ongoing discussions about Pillar 2 where strong comments have been made and would appreciate a possibility to resume consultations on Pillar 2 at an appropriate time, with a focus on Principle 3 (individual capital adequacy) and part C (specific issues in Pillar 2). The Czech National Bank does not join the banking community in raising this comment.

2. The specific issues in Pillar 2 that are quantifiable should, in the opinion of the Czech Banking Association, be moved to Pillar 1. Pillar 1 should be subsequently re-calibrated. In addition, individually determined capital adequacy should be exceptional rather than commonplace. The Czech National Bank does not join the banking community in raising this comment.

3. The Czech Banking Association supports the view that the under and overstatements of required capital should be netted off. In other words, any additional capital requirement should take into account not only understatements, but also overstatements in required capital in particular directions. The Czech National Bank does not join the banking community in raising this comment.

Interest Rate Shock in the Banking Book

part A - conceptual comments

1. In order to determine whether the bank's exposure in a given currency is substantial or residual the text uses the following criterion (article 82 of the supporting document, article 6 of Annex 3 of the supporting document). The bank should check whether the currency accounts for 5% or more of its banking book assets. From the point of view of the Czech National Bank this approach is not correct. There might be, for example, a bank with a small volume of banking book assets in a given currency and a large volume of banking book liabilities in that currency; the criterion will mark this exposure as residual, while in reality it is substantial. Therefore the Czech National Bank proposes an alternative criterion that the bank should check whether the currency accounts for 5% or more of its banking book assets or 5% or more of its banking book liabilities. If any of the two conditions is met the given currency should be treated as substantial in the context of the interest rate risk of the banking book.

2. The text does not stipulate clearly whether the interest rate shock should be calculated in each residual currency separately or in the residual currencies in total (article 82 of the supporting document, article 6 of Annex 3 of the supporting document).

3. In order to ensure objectiveness in calculating the interest rate shock, the procedure of setting modified durations in currencies and time bands should be made uniform on the international level. There are two possibilities for the Basle Committee to achieve this objective. Firstly, setting fixed numbers, secondly, setting a methodology and the frequency of updating. In addition, there should be minimum requirements in relation to the number of time bands and their lengths.

part B - technical comments

1. The description of method (a) for exposures in non-G10 currencies should be more precise (article 81 of the supporting document, article 2 of Annex 3 of the supporting document). We interpret the text in the following way. Firstly, the interest rate changes are observed and the 1^{st} and 99^{th} percentiles are chosen. Secondly, a parallel rate shock is calculated – similarly as in the method (a), using the 1^{st} percentile of the observed interest rate changes instead of 200 basis points. Thirdly, the same procedure is applied to the 99^{th} percentile. The Czech National Bank needs to confirm that the real meaning of the text conforms to this interpretation.

2. The description of method (b) should be more precise. We interpret the text in the following way. Firstly, time bands are determined and the longs and shorts in each time band are offset, resulting in a single short or long position in each time band. Secondly, the interest rate changes are observed and the 1^{st} and 99^{th} percentiles are chosen; the vertices of the yield curve at which the interest rates and the interest rate changes are observed are the midpoints of the time bands. Thirdly, the change of the present value of the net position in each time band is calculated in relation to the 1^{st} percentile, producing an overall profit or loss when the results from the individual time bands are put together.

Fourthly, the same is applied to the 99th percentile. The Czech National Bank needs to confirm that the real meaning of the text conforms to this interpretation.

Pillar 3

part A - conceptual comments

1. The Czech National Bank recommends extending the application of Pillar 3 to the sub-consolidated level. The consent of the Czech Banking Association is, however, conditional upon meeting certain additional conditions, namely:

   i) The level of detail on the sub-consolidated level will be lower than on the top of the consolidated group.
   ii) The requirements laid down by Pillar 3 will be harmonised with other disclosure requirements on banks in order to avoid unnecessary costs inflicted by duplicate disclosure.
   iii) The requirements laid down by Pillar 3 will be harmonised with disclosure requirements on non-banking financial institutions.

2. We suggest the Basle Committee to insist on the floor of the Joint Forum that adequate disclosure requirements be imposed on non-banking financial institutions.

3. In contrast to the Consultative Paper 2 the current form of the NBCA does not demand qualitative information on the evaluation of assets and liabilities, capturing income, encompassing the impact of unrealised gains and losses and deferred taxes on Tier 1. We recommend that these items be subject to disclosure. This is, however, relevant only in the case of those countries where such disclosure requirements do not follow automatically from the accounting standards.