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SWITZERLAND

THE NEW BASEL CAPITAL ACCORD

COMMENTS OF FINNISH AUTHORITIES ON THE THIRD CONSULTATIVE DOCUMENT ON THE NEW BASEL CAPITAL ACCORD

In April 2003 the Basel Committee on Banking Supervision released its third consultative document on the New Basel Capital Accord (CP3). This paper presents the views of Finnish Authorities (Bank of Finland, Financial Supervision Authority and Ministry of Finance) on the proposal. The Finnish Authorities welcome the new document. In our opinion the changes made represent important steps towards completion of the new framework. There are, however, some issues that require further exploration. Our comments on the proposal concentrate on a number of key issues and are summarised as follows.

General comments

Overall calibration of the capital requirements

An important objective stated in the first and the second consultative documents in 1999 and 2001 is that *the new framework should at least maintain the current overall level of capital in the system*. We still consider this objective to be as valid as before, and it should not be compromised in the final rounds of the review. Accordingly, the minimum capital requirements under Pillar I should produce a level of capital comparable to the present requirements, and institutions should hold sufficient capital buffers above this level. In order to ensure that financial institutions clearly recognise the necessity of having adequate buffers and that these buffers can

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be calculated consistently, *more emphasis should be devoted to issues related to building up capital buffers/provisions and to Pillar II rules in general*.

Quantitative empirical studies may somewhat overestimate capital requirements because of deficiencies in financial institutions' capabilities to fully utilise credit risk mitigation techniques in QIS 3. This, among other factors, complicates the calibration of the capital requirements. We therefore *support the Committee's proposal to establish overall floors for minimum requirements in relation to the present rules.*

Cyclicality of the new framework and possible alleviating measures

The procyclicality of the new framework is closely related to the risk sensitivity of the capital requirements and also to the overall calibration of the requirements. Some changes have been made since the January 2001 consultative document to reduce the risk sensitivity and hence the procyclicality of the IRB approach. Risk-sensitive capital requirements will always reflect developments in the business cycle, tending to decrease when the economy is growing and increase during periods of recession. After a negative shock, financial institutions have to adjust their activity based on the need to cover write-offs and to fulfil higher regulatory capital requirements. We feel that more explicit rules should be elaborated to overcome these problems.

In our understanding, remedies to alleviate procyclicality should preferably not concentrate on a further reduction of the risk-sensitivity of the framework, but rather on developments in the rules and incentives which encourage institutions to create, in a timely manner, adequate capital buffers or loss provisions and to ensure prudent lending behaviour during the periods of economic recovery. Therefore, it would be valuable if the *rules for credit risk stress testing as well as the Pillar II principles, and their application in connection with evaluating individual institutions' capital adequacy processes, were further clarified* in the final Accord documentation to take proper account of business and lending cycles. Moreover, *the possibility to develop the system and to further refine common rules for early (dynamic or 'contra-cyclical') provisions at a later stage should not be ruled out*, either.

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Pillar 2 (Supervisory Review Process) – clarification of criteria for supervisory treatment under Pillar 2

The Committee stresses Pillar 2 within the new framework as necessary for effective management of banking organisations and for effective banking supervision, respectively. The Basel CP3 document amply elaborates the need to consider capital adequacy based on an analysis of a bank's risk profile, risk management and internal control, as well as risk factors emanating from the external environment. The Pillar 2 supervisory review process is said to facilitate proper treatment of bank-specific uncertainties. The Committee underlines that the evolving nature of finance and the complex risk profile heighten the importance of, and the attention supervisors must pay to, Pillar 2.

In part 3, section A, the document singles out three main areas that “might be particularly suited to treatment under Pillar 2”, while in section C (“Specific issues to be addressed under the supervisory review process”) it also elaborates more detailed guidance for the treatment of risk factors related to these areas. These risk factors relate to a bank's current risk exposures based on its underlying business, its external environment and/or the use of specific risk mitigation techniques.

We note that “treatment under Pillar 2”, following Pillar 2 principles and section C guidance, is fundamentally a question of: (i) establishing rigorous risk management frameworks, (ii) reserving adequate capital resources against these risks, both in a bank’s own capital management and allocation processes and in the regulatory capital adequacy consideration, or finally (iii) even reducing risks. We also note that there are at least seven cross references in the text of Pillar 1 to supervisory action or treatment under Pillar 2. In many cases ‘treatment’ refers to the need to hold additional capital.

However, we note that there is still some scope to clarify in more explicit terms which of these risk factors are such that they always warrant support from capital allocated against them in the supervisory capital adequacy determination. Currently *the text is somewhat ambiguous as to the direct contribution of various factors to the expected ‘capital buffer’ under Pillar 2 above the Pillar 1 minimum regulatory capital requirement*. It is quite crucial for even-handed implementation of the New Accord that the *nature and role of, and key criteria for, a possible Pillar 2 capital adequacy requirement, over and above the Pillar 1 minimum standard, be clearly established.*

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Pillar 3 (Market Discipline) – enhancement of market disclosure requirements

Improved market discipline and transparency through Pillar 3 disclosure requirements are important aspects of the new framework. The new framework is intended to bring about significant long-term benefits by allowing market participants to better assess key information relating to a bank's risk profile, risk management and internal control and to the level of capital needed to support the overall risk profile.

In general, *we strongly support the initiatives to promote consistent, comprehensive disclosure policies and practices for institutions, as well as consistency between relevant financial information reporting and disclosure frameworks.*

Role of Pillar 2 compliance

The Basel Overview document states: "Judgements of risk and capital adequacy must be based on more than an assessment of whether a bank complies with minimum capital requirements." Considering the heightened importance given to Pillar 2 requirements, the current Pillar 3 proposal only contains one qualitative disclosure requirement calling for: "A summary discussion of the bank's approach to assessing the adequacy of its capital to support current and future activities." We note that current disclosure requirements focus very much on risk exposures, risk assessment and quantification of the Pillar 1 minimum regulatory capital requirement. We feel that *the disclosure requirement pertaining to a bank's internal process for capital adequacy assessment and its results, as well as to the supervisory evaluation of this process and any Pillar 2 capital adequacy requirement, could be more explicitly stated*. In order for market participants to form a truly considered judgement of risk and capital adequacy, they need full disclosure of a bank's compliance with Pillar 2 principles. They also need full disclosure of capital buffers as required by supervisors under Pillar 2, based on the overall risk profile and the need to carry out stress tests for certain risks.

In general, *we are in favour of disclosing overall capital adequacy requirements, including both Pillar 1 and possible Pillar 2 regulatory requirements.* We note that level playing field arguments between listed and non-listed banks is yet another reason to call for increased disclosure pertaining to Pillar 2. Listed companies must comply with the requirements of the EU directive on the admission of securities to official stock exchange listing. They are required to inform the public as soon as possible of any developments in their activities that could lead to substantial movements in their share prices. It can be argued that compliance or any non-compliance with Pillar 2 requirements qualify as such information from the point of view of market participants. In light of the stated Pillar 3 objectives, it may be questioned whether the market mechanism can be expected to work efficiently without full disclosure of overall supervisory capital adequacy requirements based on both Pillar 1 and Pillar 2 considerations.

Harmony with IASB work

Finally, we note that the IASB has tentatively agreed that IAS 1 should include capital disclosure requirements. This includes a focused discussion on the management of capital resources, incorporating capital requirements imposed by external parties, and on any non-compliance with external capital requirements. *We recommend that Basel Pillar 3 disclosure requirements maintain sufficient harmony with the IASB standards.*

Detailed comments on specific issues

Scope of Application

The text of the new Scope of Application is very compact. It would greatly ease the harmonised application of the New Accord if there were some pointers for consideration as to when, for example, the Accord should be applied on a bank-only (solo) basis, on a consolidated basis or on both bases. In paragraph 3 of the Scope of Application the general scope of application is referred to in one sentence, as follows: “The Accord will also apply to all internationally active banks at every tier within a banking group, also on a fully consolidated basis…” The text also refers to an illustrative chart at the end of the Scope of Application section. Principle 6 of the Core Principles for Effective Banking Supervision (Basel Core Principles) states: “Banking Supervisors must set prudent and appropriate minimum capital adequacy requirements for all banks.” In the text, this requirement has been defined as applying to banks on a consolidated basis. However, the footnote mentions that supervisors should, of course, also give consideration to monitoring the capital adequacy of banks on a non-consolidated basis.

Principle 20 of the Core Supervisory Principles also addresses this topic, as follows: “Supervisors should decide which prudential requirements will be applied on a bank-only (solo) basis, which ones will be applied on a consolidated basis, and which ones will be applied on both bases.” Clarification and criteria for the application of these principles would enhance their more consistent and harmonised implementation and application.

According to Scope of Application, footnote 1: “A holding company that is a parent of a banking group may itself have a parent holding company. In some structures, this parent holding company may not be subject to this Accord because it is not considered a parent of a banking group.” It would also be helpful if this footnote could be elaborated in order to clarify precisely what the structures are where the parent holding company is not considered as a parent of a banking group.

Interaction between capital adequacy and financial reporting rules

Capital adequacy and accounting requirements are interrelated in many key respects. As the Basel Committee has emphasised, sound accounting and valuation practices lay the foundation for capital requirements, and therefore it is important to pay attention to evolving financial reporting regulation. Within the European Union, financial reporting practices will be significantly harmonised as of 2005, when all listed companies operating within the EU will prepare their consolidated financial statements in accordance with International Accounting Standards. Moreover, some key standards relating to recognition, disclosure and presentation of financial instruments themselves (e.g. IAS 32 & 39, IAS 30) are currently undergoing revision.

In order to ensure the clarity and consistency of amendments, the reform of both capital adequacy and accounting standards should give consideration to their interaction. In particular, the accounting measurement is relevant to capital adequacy calculation in the context of the valuation of exposures in both the trading and banking books. Further interaction is apparent in, for example, the case of asset securitisation and operational risks (cf. business line vs IAS 14 Segment reporting). As IAS /IFRS and their amendments in certain key areas are still evolving in order to develop a robust financial reporting standards framework, it is important wherever possible to ensure avoidance of unnecessary differences in these regulations.

Special issues related to guarantees

The types of guarantees recognised in the 1988 Capital Accord are limited to certain third party guarantees. Exposures covered by guarantees of such entities attract the risk weight assigned to a direct claim on the guarantor. In addition, partial guarantees are also recognised, ie an exposure can be split into a covered and an uncovered portion. The covered portion attracts a reduced risk weight, while the remainder part will take the risk weight of the obligor. In the 1988 Capital Accord no further requirements are imposed for recognition of the guarantee.

In Finnish legislation a deficiency guarantee is defined as a guarantee where the guarantor is liable for the credit obligation in so far as it cannot be recovered from property pledged as collateral for the obligation. On the qualifying default of the counterparty, the creditor may pursue the guarantor for monies outstanding after the realisation of the credit collateral. Deficiency guarantees are typically granted by government and by Finnish municipalities and have a significant economic impact on housing finance and infrastructure investments in Finland.

A deficiency guarantee is the guarantor's unconditional and irrevocable commitment to pay, in the event of default by the debtor, to the credit institution all monies owed by the debtor according to a specific loan agreement and still outstanding after the realisation of specified pledged collateral. The credit institution can demand payment from the guarantor after the collateral has been realised or after it has been discovered in recovery proceedings that an obstacle exists to realisation of the collateral. The credit institution can also demand payment from the guarantor if the guarantor has, after the debt has fallen due, given notice that it will not demand realisation of the collateral. For economic reasons the guarantor may not want to wait for realisation of the collateral.

As far as we can see, the only open question relating to the recognition of deficiency guarantees under Basel II, is the condition that the collateral pledged to the credit institution and specified in the deficiency guarantee has to be realised first, in order to establish the precise amount of the guarantor’s commitment. In the final analysis, however, the guarantor is at all times responsible for all debt, including the principal, interest, interest on arrears, collection costs and costs accrued during the realisation process, and therefore the credit risk mitigation characteristics of these guarantees are effective.

The current capital adequacy rules recognise government and municipal deficiency guarantees. We consider that this treatment should be maintained under Basel II on the grounds that the guarantor in deficiency guarantees will always remain liable for any debt and interest still outstanding after the realisation of the collateral.

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Internal ratings-based approach

Definition of default

The days past due trigger of default should only apply when the obligation is past due because of the counterparty's inability to pay. For example, under the rules as now proposed, a highly rated guarantor (eg a sovereign) would be considered to be in default if the past due date is triggered while the guarantee is being disputed in a court of law (and the guarantor's obligation thus not being fulfilled). This would raise the capital charge of all of the guarantor's credit obligations. However, the losses resulting from such an event are already covered by the operational risk capital charge, since operational risk in the proposed framework includes legal risk.

Equity capital charges in the IRBA vs. the Standardised Approach

Equity capital charges under the IRBA simple risk weight method are too high compared with the Standardised Approach. The maximum level required by the Standardised Approach is 150 %. In our understanding there is no way in which the equity capital charge under IRBA simple risk weight method could be under the level required by the Standardised Approach. We consider that this calibration constitutes a clear disincentive to adopt the IRBA, especially since IRBA-application to the equity portfolio is mandatory upon its adoption for any other portfolio.

Retail treatment of SME exposures – the use test as eligibility criteria

Apart from the EUR 1 million exposure size threshold, the eligibility criteria for the retail treatment of small business exposures (the 'use test') are ambiguous and open to a wide range of differing interpretations. Considering the impact of the interpretation on said exposures' risk weights (whether the corporate or the other retail risk weight function is used), we find further elaboration and clarification of the eligibility criteria and the principles behind them an essential task for the Accord Implementation Group. Examples of eligible and ineligible practices would be of great value in this regard.

Definition of 'qualifying revolving exposures'

For a given set of risk parameters, the risk weight for qualifying revolving exposures (QRE) is the lowest. Therefore, it is odd that exposures which fulfil all the criteria of paragraph 202, except that they are secured rather than unsecured, should not qualify for favourable QRE treatment. This, in effect, constitutes an incentive for banks not to take collateral or guarantees.

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Furthermore, it is in contradiction to the commendable principle of paragraph 83, which states: “No transaction in which CRM techniques are used should receive a higher capital requirement than an otherwise identical transaction where such techniques are not used.” The ‘unsecured’ criterion should therefore be dropped from paragraph 202.

Recognition of future margin income (FMI)

The consultative document defines specific criteria for a certain product type, ‘qualifying revolving exposures’, and also allows the recognition of future margin income for these exposures under certain conditions. We note that there may exist other retail exposures which feature fundamental risk characteristics comparable to QREs but which do not qualify as QREs. If future margin income is recognised, it should also be allowed for retail exposures other than just qualifying revolving exposures if the institution concerned can demonstrate that the FMI covers losses, as required in paragraph 202(d). Restricting favourable treatment to a strictly defined product class seems to be based on current experience in very particular circumstances. However, if other products with comparable risk characteristics are not allowed to receive the same treatment this may unduly act as an incentive for banks to avoid rolling out such products.

Assignment of retail exposures into pools

While the characteristics which an institution is obliged to take into account in the assignment of retail exposures into pools are in themselves proper (provide for a meaningful differentiation of risk, etc), using them as pooling criteria is not the only way to take them into account in risk analysis. The characteristics can also be used as variables in the calculation of a credit score (and the exposure pools can then be formed based on the credit scores, if need be). We fear that the degree of detail in the regulation of estimation of retail exposures’ risk parameters (PD, LGD, etc) will stifle innovation in risk management in this area in the future.

Operational risk

Paragraph 609 states: “Banks are encouraged to move along the spectrum of available approaches as they develop more sophisticated operational risk measurement systems and practices.” Perhaps the incentive to move from the Basic Indicator Approach to the Standardised Approach is based more on the type of business an institution is involved in than the way it manages its operational risk. Alfa and beta are calibrated currently in such a way that there may be very little incentive to move from the Basic Indicator Approach

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to the Standardised Approach, especially if the institution is engaged in business in low beta business lines.

Paragraph 624 a) states that the bank must have an operational risk management system with clear responsibilities assigned to an operational risk management function. Management of operational risk is part of an institution's risk management system. The overall principles of risk management are stated in the document on the Framework for Internal Control Systems in Banking Organisations. These principles also apply to operational risk management. Instead of explicitly requiring a separate operational risk management function and defining how risk management should be organised, it would perhaps be sufficient simply to state that an institution should organise its operational risk management as part of its overall risk management. Operational risk management does, after all, measure, follow, control and mitigate a form of risk.

Annex 6 defines the mapping of business lines. 'Treasury' is located under the 'Trading & Sales' business line. However, footnote 155 lists "securities held in the banking book" under 'Commercial Banking'. Moreover, according to footnote 155, 'Trading & Sales' would include only "instruments held for trading purposes". Treasury activities include the investing of liquidity, securities funding and management of the interest rate risk in the banking book. It should therefore be clearly determined in which business line these activities are to be included.

The 'Trading & Sales' business line may contain negative annual results. The recommended way to include these observations would be to use absolute values.

Trading book issues

In general, we prefer that the principles of valuation defined in IAS/IFRS also be applied as regards the trading book in the capital adequacy requirements. In our opinion the valuation methods used in accounting and capital requirements should be identical.

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