THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

29 July 2003

TECH 25/03

Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Dear Sirs

The New Basel Capital Accord

The Institute of Chartered Accountants in England and Wales represents 125,000 members of the accountancy profession working in practice and in industry. We welcome the opportunity to comment on your Consultative Document "The New Basel Capital Accord", issued in April 2003. Our comments are contained in the enclosed Technical Release.

We recognise that some rationalisation of disclosure requirements has been made since the previous consultation, but note a tendency towards a rules based approach, particularly in the first and third pillars. We suggest that the introduction of some high level principles to guide disclosures might allow consistency among national regulators without becoming prescriptive.

In accordance with our normal practice for representations of this nature, we will be sending copies of our response to the International Accounting Standards Board, the UK Accounting Standards Board and the UK Financial Services Authority.

If you wish to discuss any aspects of this response further, please contact me in the first instance at the address below.

Yours faithfully

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THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

TECH 25/03

THE NEW BASEL CAPITAL ACCORD

Memorandum of comment submitted in July 2003 by the Banking Sub-Committee of the Institute of Chartered Accountants in England and Wales to the Basel Committee on Banking Supervision in response to a third consultative document, "The New Basel Capital Accord", issued in April 2003, seeking views on its proposed new Capital Accord to replace the 1998 Accord, 'International Convergence of Capital Measurement and Capital Standards'.

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Introduction

1. The Institute of Chartered Accountants in England and Wales welcomes the opportunity to respond to the consultative document issued by the Basel Committee on Banking Supervision in April 2003. The Banking Sub-Committee of the Institute represents Chartered Accountants working in practice and in the banking industry. Our comments therefore focus upon the accounting and audit issues raised by the consultative document, and in particular to those relevant to the third pillar – market discipline, which aims to encourage high disclosure standards.

2. In accordance with our usual practice in relation to documents of this nature, we are sending a copy of this response to both the UK Accounting Standards Board and the International Accounting Standards Board. In view of the subject matter, we are also sending a copy to the UK Financial Services Authority.

General Comments

3. We support the Basel Committee's efforts to promote safety and soundness in the financial system and to improve standards throughout the world. We note that this consultative paper appears to have addressed a number of the concerns raised in our memorandum of comment upon the previous consultation, submitted in May 2001. We thank the Basel Committee for listening to and taking account of the views of the accounting profession. We have not repeated in this document any comments in our previous memorandum, unless we consider that further consideration is required of a particular issue.

The First Pillar – Minimum Capital Requirements

4. The consultative paper provides a high level of detail in respect of the proposals for the first pillar. Notwithstanding this prescriptive approach, the proposals continue to include a considerable amount of discretion for national regulators in applying the proposals and note that this might lead to inconsistency and therefore significant negation of the rationale for the proposals. One approach to this issue could be to set high-level principles for disclosure, placing the onus on the banks to demonstrate how their disclosures meet these high level principles.

5. The consultative paper requires internal, but not external validation, of the accuracy and consistency of rating systems processes and the estimation of all relevant risk components under the first pillar. We welcome this clarification of the role of the external auditor. The proposals do however leave a considerable amount of discretion with management over the nature and extent of verification required. We note that the proposals will still impact the statutory audit given the duty of auditors to review information disclosed alongside the financial statements for consistency with those financial statements. In addition, the proposed new risk management and measurement requirements will make banks more complex and therefore more difficult to audit. We consider this will be a challenge for auditors rather than an obstacle to the proposals.

The Second Pillar – Supervisory Review Process

6. Much of the difficulty in implementing the second pillar will be in ensuring consistency amongst banking supervisors. In places, the proposals remain vague, in contrast to the high level of detail contained in the proposals for the first pillar. We note, for example, that it is proposed to use this pillar to counter procyclicality in credit risk provisioning without explaining how this will be achieved. A further example is that there is no clear requirement for banks to have an economic capital model but, if they have one, the regulator is bound to take this into account.

7. As with the first pillar, the second pillar proposals contain a considerable amount of national discretion. We recognise that there is a certain amount of conflict between the twin aims of flexibility to deal with specific national or arising issues and providing a suitably high level of detail to ensure consistency. We note that implementation across national borders for international banking groups will mean that there could be differences in the interpretation of Pillar 2 requirements by local regulators compared with the lead regulator. A greater degree of co-ordination between regulators is essential in order to address these issues and any steps that the Accord Implementation Group is able to take to facilitate this process would be welcome.

The Third Pillar – Market Discipline

References to International Financial Reporting Standards

8. The consultative document includes references to International Financial Reporting Standards but appears to do so inconsistently and does not do so throughout the paper. It is important that the disclosures required by the third pillar requirements are consistent wherever possible with the financial reporting requirements of banks to ensure that banks are not required to provide two different sets of data using different bases but with overlapping disclosures. An example of this is in the required disclosure of industry sector information which is not consistent with the segmental information required by IAS 14 – Segment Reporting, as noted below.

Method and Volume of Disclosures

9. We are concerned that the disclosures may be voluminous. We recognise that the disclosure requirements have been significantly rationalised since the previous consultation. While we welcome the removal of the disclosure templates as this allows banks to present information in a way that best reflects how they manage the risk, the exact nature and volume of the required disclosures is unclear. The proposals provide a considerable amount of flexibility in the method of disclosure if information, with the options of disclosure in the financial statements, in the Management's Discussions and Analysis (MD&A), as a stand-alone report or on a web-site. The length of disclosures may affect banks' decisions on where they disclose the required information. We welcome the Basel Committee's acknowledgement, in paragraph 763, that where the disclosures are made under accounting requirements, banks may rely on them to fulfil the applicable Pillar 3 expectations and that the explanation of material differences between the

accounting disclosure and the supervisory basis of disclosure does not have to take the form of a line by line reconciliation.

10. The natural home for many of the disclosures may be in the MD&A. Should the disclosures be lengthy, some banks may decide to use an alternative method of disclosure, such as issuing a standalone report. Information disclosed in the financial statements would be audited and information disclosed in the MD&A would be reviewed by the external auditors for consistency with the financial statements. Disclosures contained in a stand-alone report or on a web-site would not require to be audited, but management should ensure that appropriate verification of the information takes place. These factors may result in inconsistency in the method of disclosure used by banks, although market practice may reduce disparities over time.

Prescriptive Requirements

11. A number of the disclosure requirements appear to be rule rather than principle driven. There is a risk that certain requirements may cease to be as relevant as time passes. Reliance on a few basic principles would avoid this, although this might result in some loss of comparability.

Disclosure of Ratios of Subsidiaries

12. Quarterly disclosure of the individual ratios of significant banking subsidiaries in the consolidated disclosures might be confusing. While the individual banking subsidiary ratios might be a valuable tool in enforcing market discipline, these ratios might be equally effective and more relevant if disclosed alongside the individual subsidiary financial statements to which they relate rather than alongside the consolidated disclosures. We consider that allowing such disclosure at subsidiary level would reduce the volume of disclosures without reducing the effectiveness of the market discipline imposed. We further suggest that the Basel Committee considers allowing less frequent disclosure of the individual subsidiary ratios, such as half-yearly or annual disclosures, than the quarterly disclosure of consolidated numbers.

Disclosure on Web-sites

13. The effectiveness of disclosure on a web-site varies depending upon the design and navigability of a web-site. It can be possible to hide information on web-sites by putting it in an area which requires drilling down through several other pages of information with no clear sign-posting or logical flow. We recommend that, should web-site disclosure be allowed, there should be clear high level guidance on required prominence and ease of access, e.g. that the link to the regulatory disclosures be afforded equal prominence and accessibility as the link to the external financial statements.

Materiality

14. The consultative paper refers in paragraph 766 to materiality and defines materiality in a manner consistent with International Financial Reporting Standards and other

accounting frameworks. However, materiality can only be properly assessed in consideration of the expectations of the intended users of the accounts.

15. We consider that the likely main users of the disclosure required by the third pillar would be market counter-parties (including other banks), analysts and ratings agencies. Shareholders are unlikely in general to be interested in the level of detail and complexity contained in the third pillar disclosures and regulators themselves will receive information direct from banks. It is therefore inappropriate to use a general-purpose financial statements definition of materiality for regulatory disclosure, since the disclosure has different users to audited financial statements. The consultative paper does not make clear enough who the intended users of the third pillar disclosures should be. Without properly understanding who the intended users of the disclosures are, it is not possible to properly assess what might reasonably influence their decisions or assessments. It would be helpful if the proposals made clearer the intended users of the regulatory disclosures and framed the definition of materiality in terms of those users.

Exemption from Disclosing Sensitive Information

16. We welcome the exemption available from disclosing commercially sensitive proprietary information, with the proviso that banks will be required to disclose "the fact that, and the reason why, the specific item of information has not been disclosed." We note that this option is very flexible and consider this to be necessary as it allows banks to explain their position in a general way without losing competitive advantage by disclosing sensitive information. The exact details of what might reasonably be disclosed without prejudicing commercial interests will vary according to the nature of the sensitive information.

Industry Breakdowns

17. The requirement to disclose breakdowns of loans, allowances and charges by major industry or counter-party type might prove difficult to provide. Although many banking systems may be set up to identify their exposures by industry type, they may not allow allocation of general provisions to industry type as this would normally be done on a portfolio basis. The consultative paper does not define the categories of major industry or counter-party but the approach does not appear to be consistent with International Accounting Standard 14 – Segment Reporting.

Prospective Information

18. The implications of providing exposures at default (EADs) and probabilities of default (PDs) should be considered. This information might be used to extrapolate numbers on a prospective basis (i.e. future bad debt charges). This may be inappropriate as, generally, it is not permitted to provide detailed forward looking information alongside the financial statements. We are concerned that including this information within the third pillar disclosures might suggest an inappropriate level of precision in any forward looking estimation made on the basis of these numbers.

19. While it may be valid for regulators to be interested in this forward looking information, it may be that the second pillar may provide a better route for

obtaining this information than the third pillar. Should the requirement to include EADs and PDs in the third pillar disclosures remain, any data included in the MD&A would need to be expressed in such a way that it did not make any predictions of the future, although it might allow the market to take its own view.

Conclusions

20. We continue to support the ongoing work of the Basel Committee and their aims of promoting safety and soundness in the financial system. We recognise that the third consultative paper includes a number of areas where the disclosure requirements have been rationalised since the second consultative paper. We would like to thank the Basel Committee for the opportunity to comment on their proposals and would welcome the opportunity to comment upon any future developments.

IDC July 2003