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CABLE ADDRESS  
INTERFUND

July 31, 2003

Mr. Jaime Caruana  
Chairman, Basel Committee on Banking Supervision  
Bank for International Settlements  
CH-4002 Basel, Switzerland

Dear Mr. Caruana:

Attached are comments on the Basel Committee's third consultative paper on a new capital accord (Basel II), prepared by an interdepartmental working group and representing the views of Fund management and staff. The proposal is of particular interest to the Fund because of its potential effect on the periodic assessments of the soundness of financial systems of different countries, and has implications for the surveillance operations of the Fund. The highlights of these comments are set out below. My staff would be pleased to discuss these comments in further detail with you or your Secretariat.

**We have three broad areas of concern that relate to the implications of the Accord, its coverage, and matters of implementation.**

**Regarding the implications of the Accord, the potential remains for an uneven playing field and competitive distortions, in light of the many country options and areas of national discretion embedded in the proposals. We would support further effort by the Committee to encourage international convergence on the definition of capital, as well as loan classification and provisioning, to mitigate the potential plurality of capital regimes. The use of ratings in setting capital charges also has the potential to exacerbate pro-cyclical effects, with possible implications for greater volatility of financial markets and countries' access to international finance. While some aspects of this issue may exceed the remit of the Accord, it will be important that quality control of rating agencies and potential conflicts of interest be addressed.**

**With respect to the coverage of the Accord, risks arising from concentration of exposures, as well as foreign currency exposure and associated credit risk, especially in dollarized countries, are omitted. Both from our country work and from the evidence of the role such exposures have played in past financial crises, we feel that that these issues need to be addressed under both Pillars I and II. Moreover, notwithstanding the commendable work of making capital requirements more risk sensitive, lower risk weights for domestic currency exposures to sovereigns and government-owned enterprises could understate the risks, create competitive distortions, and, therefore, should be revisited. Further, disclosure on a quarterly**

#1970572 v2 - MFD BR DM/JWV: MD's Letter to Mr. Jaime Caruana RE: Staff Comments on Third Consultative Paper on Basel II July 31, 2003 (10:39 AM)

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basis of at least the core set of Financial Soundness Indicators (FSIs) and key information on dollarization of banking systems would also enhance the usefulness of Pillar III disclosure.

**On implementation issues, as the supervisory review process of Pillar II is key to the successful implementation of the Accord, we urge the Committee to explicitly encourage countries to achieve a high degree of compliance with the Basel Core Principles before implementation of Basel II. In addition, and as the Committee is aware, effective cooperation between home/host country supervisors will be critical, given the cross-border challenges arising from the implementation of the Accord. Finally, substantial technical assistance will be required by many countries to implement Basel II successfully, even in its simpler variants, and the Fund stands ready to participate in this process.**

**We would like to reiterate our sincere appreciation for the exhaustive consultative process undertaken by the Committee, going well beyond its traditional membership. This consultative process should result in a higher level of "ownership" by the global banking and supervisory communities and will enhance the applicability of Basel II by all countries.**

Sincerely yours,

A handwritten signature in black ink, appearing to read "H. Kohler". The signature is written in a cursive style with a prominent initial "H" and a small heart-like flourish above the "o".

Attachment

ATTACHMENT

INTERNATIONAL MONETARY FUND

IMF Staff Comments on the April 2003 Consultative Paper (CP3) on  
the New Basel Capital Accord (Basel II)

Prepared by an Interdepartmental Working Group

I. GENERAL COMMENTS

1. Fund staff endorses the objectives of the New Basel Capital Accord to move toward closer alignment of capital requirements with banks' actual risks, better risk management by banks, improved banking supervision, and more emphasis on disclosure and market discipline. Staff appreciates the efforts made by the Basel Committee in following a wide and exhaustive consultative process, in the course of which a number of concerns expressed by commentators on the previous consultative paper (CP2) have been addressed in this consultative paper (CP3).

2. The introduction of country options in CP3 makes Basel II accessible to many countries but could lead to an uneven playing field. In its comments to CP2, Fund staff advocated introducing a less complex option which would allow more countries to introduce Basel II, and thus contribute to a common regulatory framework. The introduction of country options in CP3 makes Basel II more accessible to many countries. The many options and areas of national discretion embedded in the Accord may, however, lead to an uneven playing field. Competitive distortions among institutions could arise from differences in the implementation of the Accord, as well as from national differences in some underlying standards, for instance, on accounting and provisioning. In work in various countries, staff has encountered numerous instances of such differences, leading to capital adequacy measures being inconsistent and incomparable even under the existing Accord.

3. Potentially, differences in the capital measures between countries could still remain even after consistent implementation of the new framework. To mitigate this outcome and to assure the proper functioning of the Accord, staff strongly urges the Committee to work toward obtaining agreement on greater uniformity in the definition of qualifying capital as applied by different jurisdictions. Staff also supports additional work that will lead toward a greater convergence in the standards on the valuation of loan assets and their classification and provisioning norms. Additionally, to reduce cross-border differences and a plurality of capital regimes internationally arising from differences in accounting, the Accord could include language to encourage supervisors across countries to seek common approaches.

4. There are also concerns regarding the pro-cyclical effects of the proposals, which may heighten credit constraints during economic downturns. Staff supports further study and testing of these pro-cyclicality effects. In its earlier comments, Fund staff noted that external ratings of a country's banking system, as well as internal ratings, may reinforce each other and contribute to greater market volatility and pro-cyclicality. While the Basel

Committee has made modifications in the risk weight functions in the Accord to mitigate the potential pro-cyclical effects, staff suggests that further work could focus on (i) assessing the quality and performance of both external and internal ratings as their accuracy could influence capital flows to emerging markets and contribute to pro-cyclicality, (ii) identifying incentives to encourage banks to adopt ratings that see 'through the cycle,' and (iii) making stress tests an integral part of all approaches and not just for banks using Internal Ratings Based (IRB) approaches. Furthermore, more explicit guidance is needed on the link between the results of stress tests of pro-cyclical effects and the level of required capital in Pillar I.

## II. COMMENTS ON THE THREE PILLARS OF THE NEW CAPITAL ACCORD

### A. Pillar I—Minimum Capital Requirements

5. **Although we support the work undertaken to make the minimum capital requirements more risk sensitive, concerns regarding the risk-weighting framework still remain.** For instance in the standardized approach, a lower risk weight for exposures to sovereigns denominated in domestic currency could understate the risk of this class of claims, as recent experience has shown. Similarly, a zero risk weight for government-owned enterprises may not be justified based on the legal structure and could give these enterprises preferential lending terms compared to privately owned enterprises with similar credit risks. Further, the dependence on external rating agencies in the standardized approach raises issues of quality and their impartiality, and it is important that these be addressed through more specific guidance in the document.

6. **There is a need for further empirical studies toward better aligning risk weights with actual risk for some classes of exposures and for more guidance on a methodology for verification of key default statistics viz. probability of default (PD), loss given default (LGD), and exposure at default (EAD).** The calibration of the IRB approaches in Pillar I still shows certain inconsistencies that could lead to inappropriate allocation of capital and also distort competitive positions among banks in the same jurisdiction, if capital requirements differ for exposures that have the same level of credit risk. Some of the revisions in risk weights made in CP3 may not appropriately reflect credit risks across asset classes. The ranking of the IRB risk weight functions—with the highest risk weights for large corporates and sovereigns, somewhat lower risk weights for small- and medium-sized enterprises, and the lowest for revolving retail credits—is counter-intuitive. Similarly, mortgages of equivalent actuarial credit risk are deemed to be safer than the sovereign debt of the government in which the residence is located. The Committee should make explicit the factors that may warrant such a differentiation and provide supporting evidence.

7. **Concentration of exposures can add considerably to credit risk and thus require capital charges to offset the additional risk.** Therefore, risk concentration should not exclusively be dealt with in Pillar II on supervisory review, but also in Pillar I. This issue, in particular, arises with regard to concentration in counterparty risk as a result of OTC derivatives positions. In light of the high degree of concentration among credit derivatives

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market makers, the proposed rules could deliver excessive capital relief on credit risk mitigation through these instruments, since risk concentration is not explicitly taken into account.

#### **B. Pillar II—Supervisory Review Process**

8. While Basel II is expected to lead to better banking supervision, Fund staff, nevertheless, considers it extremely important that countries that are contemplating the implementation of Basel II have established a solid system of baseline supervision, i.e., a good level of compliance with the Basel Core Principles for Effective Banking Supervision. This would enhance countries' capacity to implement the supervisory review process described in Pillar II. In their financial sector assessments of member countries, the World Bank and the IMF have noted many deficiencies in the areas of management of risks, lending practices, consolidated supervision and accounting, and prompt and effective remedial action, all of which are key to successful implementation of Basel II. Considerable upgrading of supervisors' technical supervisory skills will be required, and the international community will need to stand ready to provide assistance as needed.

9. Risks arising from foreign currency exposure in the banking system need to be addressed in the Accord, particularly in light of the experience of many crisis episodes and increasing dollarization in a number of countries.<sup>1</sup> Pillar II elaborates on specific issues that should be addressed under the supervisory review process, but omits the important risks of foreign currency exposure and associated credit risks to the banking system. The supervisory review should specifically focus attention on the risk arising out of banks' foreign currency exposures, especially in the presence of strong incentives for mismatches (e.g., fixed exchange rate regimes and large interest rate differentials). Foreign exchange risks could be explicitly included among the risks that should be followed under supervisory review.

#### **C. Pillar III—Disclosure and Market Discipline**

10. Fund staff strongly endorses the enhanced disclosure envisaged in Pillar III, as supervision can be supplemented through greater disclosure and the exercise of market discipline. However, there are concerns that key, risk-relevant data, not usually available in the annual financial statements of banks, have not been included in the disclosure regime. For instance, foreign/domestic currency breakdowns of assets and liabilities are crucial to assessing the risks inherent in dollarization. Categories for sovereign lending, lending to publicly controlled corporations, and for nonresidential real estate would also be desirable to

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<sup>1</sup> An analysis of the particular vulnerabilities faced by dollarized economies is discussed in a recent IMF Board paper, "Financial Stability in Dollarized Economies," (SM/03/112, April 2003).

obtain a better view of the institution's risk profile. Staff also suggests that banks be required to disclose the core Financial Soundness Indicators (FSIs) developed by the Fund, as these are material to risk assessment both at the institution and aggregate level. Supervisors should disclose the areas where national discretion has been applied; quantitative information on the ratings distribution of credit protection providers should be supplied.

11. **As quarterly supervisory reporting is a generally accepted practice, staff reiterates its strong preference for Pillar III dissemination on a quarterly basis instead of semi-annual as currently proposed. The disclosed information as envisaged under Pillar III would also be more useful when accompanied by income and balance sheet information.**

12. **The concepts and definitions on which the disclosed data under Pillar III are based should be made available to allow cross-country comparisons. Analysis of the disclosed information would be further strengthened by the harmonization of the underlying accounting and statistical standards. Significant additional benefits can be achieved through use of standard formats for presentation of metadata (textual descriptions of data), internet-based data collection systems, application of Extensible Markup Language (XML) techniques, flexible database construction, and data gateways.**

13. **The information issued on the basis of Pillar III will potentially have significant impact on the markets, and its accuracy and verification is, therefore, important. The role and responsibilities of the banks and the supervisors with regard to the quality of the disclosed data requires further elaboration. In particular, national supervisors or other authorities should explicitly be assigned some responsibility for monitoring the reliability of data disclosed by banks. They may need to be given powers to impose penalties in cases of incomplete, misleading, or false disclosures.**

14. **While the concept of subconsolidation is useful and will allow a more nuanced picture of the risk profile of an institution, it also implies that the supervisor at the level of the subconsolidated entity or entities potentially bears responsibility for overseeing the quality of the administrative and data systems in the subconsolidated entities. In this context, the Accord needs more clarity regarding the concept of subconsolidation and its implications for home/host supervisory cooperation and division of responsibilities. For instance, Pillar II requires ensuring that "individual banks are adequately capitalized on a stand-alone basis," while CP3, at the same time, states that Pillar III applies to the group as a whole, including any holding companies.**

### III. COMMENTS ON IMPLEMENTATION ISSUES

15. **Recognizing that implementation of Basel II will be a challenge for banks and their supervisors. Fund staff welcomes the more flexible time frame for phasing in the implementation of Basel II. The Accord could encourage countries that decide to move towards Basel II to develop and make known, in advance of the implementation, their strategy and timetable for making the transition to the new framework, addressing issues**

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such as the options of Basel II which will be applied, the banks to which the accord will apply, and how and when banks and supervisors will be capable of implementing and supervising the new Accord.

16. **Significant resource issues will still need to be addressed and managing the transition well will be crucial, especially in developing and emerging market countries.** The Accord should make reference to the documents prepared by the Accord Implementation Group on cross-border supervisory cooperation and coordination, as well as to the document "Implementation of Basel II: Practical Considerations," prepared under the auspices of the Core Principles Liaison Group. The Accord could explicitly discuss home/host regulator issues and could provide guidance for the assessment of a banking group by its host regulators. The Committee would need to work closely with non G-10 countries in managing the transition to Basel II, assuring sufficient technical assistance and guidance. In this context, Fund staff appreciates the work being done by the Accord Implementation Group and encourages it to take full account of the position of the emerging and developing countries and the challenges the new Accord poses for them. For its part, and based on its understanding of different supervisory systems gained through the FSAP, Fund staff stands ready to work together with the Committee.

17. **Finally, the Committee should consider taking on the task of maintaining a data base of the different options applied in different countries and the areas of national discretion, so as to facilitate information on, and comparability of, regimes and approaches.** Fund staff stands ready to work with the Basel Committee on these issues.

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