KREDITTILSYNET NORGES BANK

RESPONSE TO THE BASEL COMMITTEE'S THIRD CONSULTATIVE DOCUMENT

THE NEW BASEL ACCORD

1. On 29 April 2003, the Basel Committee on Banking Supervision (BCBS) released its third consultative document on the New Basel Capital Accord. This consultative statement was prepared jointly by Kredittilsynet and Norges Bank[1]. Attached are copies of the statements from FNH (the Norwegian Financial Services Association) and Sparebankforeningen (the Norwegian Savings Banks Association).

GENERAL OBSERVATIONS

2. Kredittilsynet and Norges Bank welcome the third consultative document (CP3) issued by the BCBS. We are in favour of a revision being carried out of the current capital adequacy rules and remain supportive of the underlying principles of the proposal. Although significant progress has been made since CP1 and CP2, we would like to draw the attention to some particular issues we believe deserve consideration before the New Accord is finalised.

Harmonised international standards

3. It is of decisive importance to reach broad agreement on the New Accord to ensure the necessary legitimacy and status of the Accord as an international standard in the promotion of financial stability and sound banks. Further, dissimilar rules in various countries can give rise to "regulatory arbitrage", with banks deciding to being established in countries with the most liberal regulatory framework. As capital mobility increases, it is important to have common rules in order to ensure financial stability.

Complexity, level playing field and harmonised supervision

4. Overall, the regulatory framework of the New Accord is substantially more complicated and extensive than the current capital requirements. A complex framework containing a series of options for implementation (at national discretion) and the possibility of different interpretations and application by both banks and supervisors could easily conflict with the basic principle of a level playing field. Moreover, a complicated regime may lead to a situation where only a few persons within the institutions and the supervisory authorities are familiar with the rules and the key factors that determine the bank's capital requirement. Kredittilsynet and Norges Bank would therefore invite the BCBS to search for further simplifications where possible.

[1] Kredittilsynet and Norges Bank also provided comments to the first and second consultative documents in 1999 and 2001.

5. Pillar 2 entails a substantial change in supervisory methods. The proposal implies that the supervisory authorities will be taking a more active role in evaluating and recognising the risk management systems used by banks, as well as assessing the overall risk and the level of capital adequacy. Pillar 2 will increase and highlight the need for harmonisation of international supervisory practices in order to ensure a level playing field. Kredittilsynet and Norges Bank would therefore invite the BCBS to give more precise guidelines for the implementation and application of the second pillar.

Level of capital

6. Kredittilsynet and Norges Bank support the intention of the BCBS to calibrate the new regime so that the minimum capital requirements for banks using the Standardised Approach, taking into account the new operational risk charge, should on average be the same as under the 1988 Accord. Furthermore, we support the intention that, as regards capital requirements, moderate incentives should be provided for institutions to apply more advanced approaches. The BCBS states that the results from the QIS3 exercise seem to be in accordance with the intentions of the calibration of the proposal. Kredittilsynet and Norges Bank would, however, point out that the QIS3 results show a considerable impact in pillar 1 for the regulatory retail portfolio including mortgages and small-and medium-sized enterprises (SME) in the Internal Ratings-Based Approach (IRB). This entails a significantly lower capital requirement for the so-called group 2 banks, including the four Norwegian banks participating in the QIS3[2].

7. Prices for residential real estate have in many countries risen considerably in the last decade. It is therefore possible that banks using the internal ratings-based approaches have underestimated the risk on residential real estate in QIS3, and should prices become more volatile, a larger portion of capital for such loans may be required. The proposal of the BCBS to reduce the risk weight from 40% to 35% in the standardised approach is a direct consequence of the low capital requirements that follow from the IRB approach. Kredittilsynet and Norges Bank are also of the opinion that the impact of the reduced capital requirement for SMEs is an area that should be monitored closely over the first years of implementation.

8. In co-operation with FNH and Sparebankforeningen, Kredittilsynet and Norges Bank have conducted a survey of the impact of the Standardised Approach to credit risk and the Basic Indicator Approach to operational risk on a selected group of 21 Norwegian banks (15 savings banks and 6 commercial banks). These banks are small and medium-sized and did not participate in the QIS3 exercise. The results show an overall reduction in the capital requirement of 10% for the savings banks and 1% for the commercial banks. The outcome of the survey has been set out in paragraphs 69-80. The relatively strong impact on the savings banks is, like the QIS3 results, mainly driven by lower risk weight for residential property, but retail (including small businesses) also contributes to a significant reduction in the capital requirement.

9. The Norwegian survey and the QIS3 exercise cover 84% of total assets in the Norwegian banking system. Combining the results from both exercises, the weighted average reduction in capital requirement for credit risk is 32%. Operational risk contributes to a 7% increase, which gives an overall reduction in the capital requirement of 25% for the

[2] Two of the banks were not reported to the BCBS as they are subsidiaries of foreign banks.

participating banks[3]. Such a significant reduction in capital requirement may thus have a major impact on the aggregate level of capital in the Norwegian banking system.

10. We would furthermore like to point out that the QIS3 exercise is calculated on the basis of banks' current portfolio compositions. As banks adapt to the new rules, we may witness an increase in their exposures in areas where capital requirements are reduced. If banks gradually change their portfolio composition to the new rules, the aggregate level of own funds may be reduced by more than one might expect from the QIS3 results. If portfolio adjustments are fully matched by a reduction in risk exposures, this would be consistent with the aims of the new system. However, the fact that the impact might indeed be significant suggests that one should consider moving forward cautiously. During the final stages of concluding the New Accord, the BCBS ought to take this aspect into consideration.

11. Kredittilsynet and Norges Bank note that the structure of the floor capital requirement has been revised so that a single overall floor will apply for the first two years following implementation[4]. In order to ensure transparency as laid down in the third pillar and consistency with the standardised approach, we hold the opinion that IRB banks should also publish their capital ratio based on the standardised approach after the first two years of implementation. To ensure satisfactory monitoring of the banking and financial system in its entirety, calculations ought to be made according to the standardised approach at least twice a year for a transitional period. For monitoring purposes, annual calculations for a longer period should also be considered.

12. Lastly, Kredittilsynet and Norges Bank emphasise the importance of the second pillar to ensure that banks are adequately capitalised according to overall risk profile and that each bank has a sufficient buffer of capital to meet unforeseen losses in recessions. Improved risk management in each bank and more comprehensive supervision will also be crucial to identifying and managing risk.

Definition and composition of capital

13. The New Basel Accord increases the need for a review of the capital structure. In our view, the present framework entails an overly complex capital structure in banks. A hierarchy of instruments in an institution's capital base could impede a speedy solution to an acute solvency problem. The main focus should be on Tier 1 capital, which is the real buffer during a crisis situation.

Accounting rules

14. Under the capital adequacy rules, statutory minimum requirements are calculated on the basis of accounting principles. Adequate, harmonised accounting principles are consequently a precondition for a consistent calculation of capital. Harmonised accounting rules are also important in securing a level playing field across national borders. Different

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[3] The figures from the QIS3 exercise are based on Foundation IRB. There are several potential IRB banks among the banks that participated in the Norwegian survey. It is therefore possible that the overall reduction in capital requirements will be greater than 25%. The Norwegian survey is, as explained in paragraph 8, calculated according to the Standardised Approach.

[4] Beginning year-end 2006 and during the first year following implementation, IRB capital requirements for credit risk together with operational risk and market risk capital charges cannot fall below 90% of the current minimum required for credit and market risks, and, in the second year, the minimum will be 80% of this level.

valuation rules may substantially affect the size of equity capital, which could in turn lead to competitive distortions.

15. According to EU regulation 1606/2002, international accounting standards must be applied as from 1 January 2005 for listed companies' consolidated accounts. The regulation provides the option to extend the accounting standards to unlisted companies and annual accounts. Accounting rules for listed and unlisted banks may therefore vary from country to country.

Market discipline

16. The third pillar, market discipline, represents an important part of the totality of the new aggregate system for capital adequacy. Measures to ensure both increased transparency and harmonisation of standards for external reporting are important for market disciplinary mechanisms to function. Greater transparency and access to information about the capital and risk exposures of banks will be of major significance when the considerably more complicated and extensive capital requirements are in place.

SPECIFIC REMARKS

SCOPE OF APPLICATION

17. The Committee's proposal maintains the demand for compliance with the capital requirement at every tier within a banking group, as illustrated at the end of Part 1. Kredittilsynet and Norges Bank remain supportive of a demand for compliance at each level and believe that the application of capital requirements on an individual basis, a sub-consolidated basis and a fully consolidated basis will help ensure that capital is being allocated in proportion to the degree of risk in various parts of the group. A requirement for compliance on a layer by layer basis will protect the interests of clients of individual institutions both by ensuring that regulatory capital is readily available and by paving the way for the correct distribution of regulatory capital costs within the group.

18. We reiterate our support for the Committee's proposal for a full consolidation of banking, securities and other financial subsidiaries and that the demand for consolidation be expanded to include bank holding companies. With regard to the treatment of minority interests, we assume that this capital will be available to cover losses in the subsidiary in which the capital has been invested, but that the minority interests' share of any surplus capital in the subsidiary will not be transferable within the group. Consequently, in the consolidated accounts, deductions should be made for the minority interests' share in any surplus of own funds in the subsidiary over and above the amount of regulatory capital required. The minority interests' share in a surplus of own funds may, for example, be calculated so that the surplus of own funds is multiplied by the minority interests' share of the subsidiary's total own funds.

19. With regard to the section on insurance companies, we note that one approach might be to deduct regulatory capital investments, but that a group-wide perspective for determining capital adequacy and avoiding double counting of capital may be applied. Under the alternative with a deduction, it is stated that "*the bank would remove from its balance sheet assets and liabilities, as well as third party investments in the subsidiary*" (Paragraphs 8 and 11). We believe that if *balance sheet* was replaced by *consolidated balance sheet,* the wording would be less ambiguous. The proposal would then read: "*…the bank would remove from its consolidated balance sheet assets and liabilities, as well as third party investments in the subsidiary".*

20. In section F on deduction of investments, two new items have been added: paragraph 19 concerning deduction for goodwill from tier 1 and paragraph 20 concerning clarification of the limits on tier 2 and tier 3 capital and on innovative tier 1 instruments. We are generally in favour of these additions. The proposal concerning deduction for goodwill from Tier 1 will bring the deduction approach and consolidation closer together by deducting goodwill from Tier 1 in the same manner as goodwill relating to consolidated subsidiaries. Nevertheless, differences between the two methods will still remain, e.g. as regards loans and off-balance sheet exposures within the group.

THE FIRST PILLAR – MINIMUM CAPITAL REQUIREMENTS

The Standardised Approach

21. Kredittilsynet and Norges Bank remain supportive of the main principles of the standardised approach. The standardised approach will be an important alternative as many smaller and medium-sized banks will neither have the need for, nor be in a position to avail themselves of the internal ratings-based approaches.

Risk-weighting of regulatory retail exposures and claims secured by residential property

22. An important development since the CP2 is the specific treatment of retail exposures where the risk weight has been lowered from 100% to 75% (paragraph 43). Further, the risk weight for residential property has been reduced from 50% to 35% (paragraph 44).

23. As mentioned under the general remarks, a survey of the impact of the standardised approach has been conducted on a selected group of 21 Norwegian banks. The results show an average reduction in the capital requirement for credit risk of 17% for the savings banks and 8% for the commercial banks. Including the capital requirement for operational risk the average reductions are 10% and 2%, respectively. Based on the results from QIS3 and the Norwegian survey, Kredittilsynet and Norges Bank would therefore invite the Committee to reconsider the proposed risk weight for claims secured by residential property and retail exposures[5]. Kredittilsynet and Norges Bank are, however, of the view that increased capital requirements for residential property cannot be considered in isolation for the standardised approach, but must be seen in conjunction with similar capital requirements in the internal ratings-based approach.

24. Regarding retail exposures, Kredittilsynet and Norges Bank are of the opinion that the definition of "small business" (paragraph 44) should be made more explicit. Our experience from the impact studies indicates a substantial element of subjective judgement both by banks and supervisors, which is an important level playing field issue. It should also be taken into consideration that a less explicit definition could enforce a practice where a larger portion than intended of corporate exposures is classified as "small business".

Risk-weighting of banks

25. Although alternative 1 is not in accordance with the principles of risk-based weightings there are considerable disadvantages to small countries with small banks under alternative 2 (paragraph 34-38). These banks will only to a minor extent be rated and will thus be allocated a risk weighting of 50%. Kredittilsynet and Norges Bank therefore support alternative 1, which will entail that banks are allocated risk weightings according to the country's risk class.

Recognition of external credit assessment institutions (ECAI)

26. According to paragraph 61, the assessment of an ECAI should be based on methodologies combining both qualitative and quantitative approaches. Kredittilsynet and Norges Bank would like to stress the importance of this requirement since an assessment that only depends on quantitative measures (such as accounting figures) will not capture all the

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[5] Regarding residential property, a possible solution would be to increase the risk weight from 35% to 40%. Another possibility is to introduce explicit loan-to-value ratios (LTV) in the New Accord. Several countries operate with a favourable risk weight (50%) for residential property within a LTV-ratio of 80% under the current Accord. It is therefore possible to retain the 35% risk weight, but to introduce an LTV-ratio of 60% in the New Accord. Loans outside the LTV-ratio of 60% could be risk weighted 75% as other retail exposures.

risk characteristics of an entity. It is of decisive importance that the assessment also includes judgement of the quality of management, strategy etc.

Credit risk mitigation

27. Kredittilsynet and Norges Bank are in principle in favour of greater acceptance of the use of risk mitigation techniques in the capital adequacy context. We consider it important to create incentives in the form of capital relief for the use of such techniques when the transfer of risk is real and irrevocable. The New Accord sets forth a number of methods, ranging from simple to sophisticated, for achieving this.

Financial collateral

28. To calculate the effect of financial collateral, four different methods have been introduced. Kredittilsynet and Norges Bank see the logic of having a comprehensive approach that provides incentives for advanced risk measurement as well as a simpler method for less sophisticated institutions. However, having too many approaches can make the regulation complex and difficult to manage. The comprehensive approach allowing the banks to use their own estimated haircuts will require the supervisory authorities to assess whether the criteria in paragraph 127-136 have been met. Kredittilsynet and Norges Bank would invite the Committee to consider whether it might be possible to simplify the proposal.

29. In addition, it is the opinion of Kredittilsynet and Norges Bank that the simple approach should also be available for the trading book as well as the banking book for banks using the standardised approach for credit risk. It will be an unnecessary burden to require the comprehensive approach for banks with relatively small and insignificant trading portfolios.

30. The condition for financial collateral to be recognised in the simple approach (paragraph 153), which states that *the collateral must be marked to market and revalued with a minimum frequency of six months,* seems too lenient. Kredittilsynet and Norges Bank think that there should be a requirement to revalue the collateral *with a minimum frequency of three months.*

Credit derivatives

31. According to paragraph 163, only credit default swaps that provide credit protection *equivalent to guarantees* will be eligible for recognition. Kredittilsynet and Norges Bank interpret this to include the requirement that credit derivatives such as guarantees are required to cover all types of payments (principal coupons), cf. paragraph 161 c). If this is the case, there should be some clarification as to how to handle credit derivatives that do not cover interest overdue.

32. The risk weighting principle for banks' (as a protection provider) exposures in first- and second-to-default credit derivatives are described in paragraphs 177 and 179 respectively. As these are assets or off-balance sheet items, their treatment should be described under paragraphs 54 or 55 (in the same way as exposures through guarantees), or at least there should be a cross reference to the CRM paragraphs. Kredittilsynet and Norges Bank also think there should be a sentence in paragraph 54 describing the treatment of exposures through credit-linked notes.

The Internal Ratings-Based Approach

33. Kredittilsynet and Norges Bank remain supportive of the internal ratings-based approaches (IRB) and the incentives towards risk-based models that are embedded in the proposal. The proposal will contribute to increasing the quality of risk management and to more wide-spread use of risk-based pricing.

Pro-cyclicality and stress tests

34. Kredittilsynet and Norges Bank welcome the efforts to reduce the pro-cyclical effects of the IRB approach. In addition to flattening the risk weight curves, the BCBS proposes stress testing as a means to develop capital buffers above the minimum requirement.

35. The provisions on stress tests (paragraph 396-399) in pillar 1 could be further supplemented with guidelines for supervisors on how institutions are supposed to conduct the tests. We note that the current proposal, despite several examples of possible stress scenarios to be considered, leaves considerable room for discretion, which may indeed be decisive for the institution's capital charges.

36. The pro-cyclical effects of the New Accord also depend on the time horizon applied by banks in their rating process. Kredittilsynet and Norges Bank therefore support the reference that although the time horizon used to estimate the probability of default (PD) is one year, banks must use a longer time horizon in assigning ratings (paragraph 376).

Asset classes

37. Kredittilsynet and Norges Bank would like to see clearer distinctions between the Corporate and Specialised Lending (SL) asset classes. For example, it is not clear whether the Income Producing Real Estate (IPRE) definition excludes a real estate company with more than one property (paragraph 194 uses “the asset” and “a property” in singular form), and if not, how well diversified it should be in order to be considered non-SL corporate. In addition, there is considerable room for discretion on the interpretation of “primarily” and “primary”. We have the overall impression that there is a need for clarification.

Real estate

38. Kredittilsynet and Norges Bank believe that the treatment of commercial and residential real estate as collateral and real estate lending in general could be clarified in the proposal. These rules can be found at different places in the text and crucial elements are placed in footnotes on different pages (paragraphs 47, 470, 471 and footnotes 21, 83, 84).

Transition arrangements

39. In general we find it important that the banks’ IRB systems are relatively well developed and integrated into their business at the time the banks apply for recognition from the supervisory authority. It is therefore important to avoid a situation where the legitimacy of the New Accord is undermined as a result of pressure for increasingly more liberal implementation, and where the transitional provisions become permanent.

40. More specifically, we are concerned about the relaxation of the PD time series from five to two years (paragraph 234). We believe that five years as the PD time series requirement is already short. Further, we question the relaxation of the requirement that banks’ rating systems must have been broadly in line with minimum requirements for the three years prior to qualification (paragraph 233). However, the Loss Given Default (LGD)

for retail, is, in our opinion, justified and this floor – or an LGD floor as such – could well be upheld as part of the general rules (paragraph 235).

Risk weight functions

41. The firm-size adjustment for small- and medium-sized enterprises applies to corporate exposures where the reported sales for the consolidated group of which the firm is a part is less than €50 million (paragraph 242). Supervisors may also permit banks to substitute total assets for total sales (paragraph 243). Kredittilsynet and Norges Bank believe that the rule in such cases should be changed so that neither total sales nor total assets exceed €50 million.

Maturity

42. The New Accord specifies effective maturities to be required only in the advanced internal ratings-based approach (paragraph 288). In the foundation approach, the rules specify either the 2.5 years maturity or effective maturities subject to national discretion. Maturity has a definite impact on risk and Kredittilsynet and Norges Bank are of the opinion that this risk should be reflected in the capital requirement. Further, if the effective maturity requirement is communicated to the banks at an early stage, it should not be a major burden for banks when preparing for the implementation of the New Accord. Against this background, Kredittilsynet and Norges Bank propose that the national discretion option be removed and that compulsory effective maturity requirements in the Foundation IRB should be introduced.

Equity exposures

43. The proposal specifies risk weights of 100% in the standardised approach versus 300-400% in the simple risk weight method under the IRB approach (paragraphs 53, 54 and 315). Kredittilsynet and Norges Bank believe that the risk weights applicable to equity holdings under the IRB simple risk weight method and the standardised approach should be further aligned. We believe that there is no justification for this vast difference in risk weights.

Provisions

44. Kredittilsynet and Norges Bank welcome the proposal for recognition of provisions to offset expected loss, as the proposal provides incentives for banks to undertake sound and timely provisioning (paragraphs 342 and 348). The proposal concerning inclusion of general provisions in Tier 2 capital is an issue that should probably be addressed in a future revision of the definition of capital (the numerator).[6]

Validation

45. Kredittilsynet and Norges Bank welcome the progress on the provisions regarding validation (paragraphs 463-468). We are, however, of the opinion that these requirements could be expanded even further by focusing more on quantifying statistical evidence. Further, to ensure that the validation methods remain stable through the economic cycle, it is essential to have adequate data, in particular sufficient time series. We support the proposal's encouragement of banks that rely on supervisory Loss Given Default (LGD) and Exposure at Default (EAD) estimates to compare these to the realised figures in order to assess economic capital.

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[6] The QIS3 exercise revealed different interpretations of the treatment of general provisions by both banks and supervisors. Banks in jurisdictions that do not allow general provisions to be included in Tier 2 capital experienced a significant reduction in the capital requirement if the total amount of general provisions was used to offset expected losses. If however, the banks calculated a theoretical cap of 1.25% of risk-weighted assets, general provisions that exceeded this maximum amount would in many cases be close to zero and have an insignificant impact on the capital requirement.

Securitisation Framework

46. Kredittilsynet and Norges Bank welcome an international standard on the treatment of securitisation in the capital adequacy context.

47. A new Act regulating securitisation of loans was adopted by the Norwegian parliament (the Storting) early in November 2002 (not yet in force). A major concern in the preparation of this Act was the requirement to have a clear break between the operating financial institution and the special purpose entity that securitises the loans. The New Basel Capital Accord defines clear terms and conditions for ensuring a clear break between the portfolio sold and the lender bank. This is a precondition if the bank no longer has to calculate capital requirement for the portfolio sold. The proposal in its present form will be a positive contribution towards a harmonisation of the regulatory framework for securitisation in the various countries.

Operational Risk

48. Kredittilsynet and Norges Bank continue to support the principles in the proposal and are of the opinion that the proposal can be expected to increase awareness of these risks and provide incentives for better control and management.

49. Kredittilsynet and Norges Bank highlight the importance of defining and explaining properly the different risks included in the proposal. In the advanced methods, banks are supposed to collect data to support their estimates of losses caused by risk inherent in the business. Lack of clear definitions and division between risks will cause confusion and might lead to differences in implementation and practice. Especially for IRB banks, there is a need for clarification as to which losses should be identified as non-credit risk.

50. On a general note, Kredittilsynet and Norges Bank are concerned with the option of choosing between the different approaches. We therefore support the currently proposed rule that institutions are not permitted to revert to a simpler approach without supervisory approval (paragraph 611). We point out that institutions whose main activities are Corporate Finance, Trading and Sales, and Payment and Settlement have no incentive to move from the Basic Indicator Approach (BIA) to the Standardised Approach. We also question whether any institution eligible for the Advanced Measurement Approach (AMA) for part of its operations will need to employ the BIA, rather than the standardized approach, for any of its portfolios. The qualifying criteria – which we support – for the standardised approach should be within reach for institutions eligible for the AMA for part of its operations.

51. Kredittilsynet and Norges Bank emphasise the need to assess the tail of the loss estimates and to validate the risk measures as put forth in the current proposal. Considering that five years of internal data will not cover infrequent serious incidents, we strongly support the requirement for external data in conjunction with scenario analyses.

Trading Book issues

52. Kredittilsynet and Norges Bank are of the opinion that the concept of *valuation reserves* is ambiguous, and paragraph 659, stating that "*valuation adjustments must impact regulatory capital*", needs clarification.

THE SECOND PILLAR – SUPERVISORY REVIEW PROCESS

53. Kredittilsynet and Norges Bank support the basic premise behind the second pillar – the Supervisory Review Process. Pillar 2 may promote sound practices in the banking industry by means of effective supervision of banks at the same time as the banks are given an incentive to develop and improve their risk management systems.

Interaction between Pillar 1 and Pillar 2 requirements

54. One of the fundamental principles and concepts of the Supervisory Review Process is to ensure that banks have adequate capital to support all the risks in their business. Kredittilsynet and Norges Bank find that the interaction and hierarchy between Pillar 1 and Pillar 2 and the detailed capital requirements that are contained in both pillars could be more clearly defined in the New Accord with regard to determining institutions' overall capital adequacy.

55. Our understanding is that the Pillar 1 capital requirement is regarded as a minimum requirement. Further, the specific Pillar 2 charges (interest rate risk in the banking book, pro cyclicality, residual risk, concentration risk and securitisation) are add-ons to the Pillar 1 minimum capital requirements. In addition, supervisors may need to add further Pillar 2 charges to cover risks not addressed by either the Pillar 1 charge or the Pillar 2 specific charges. These additional requirements may, for example, reflect inadequacies in systems and controls that are not otherwise captured in the Pillar 1, or specific Pillar 2, capital charges.

56. The New Accord is less clear with regard to the interaction between the Capital Adequacy Assessment Process (CAAP) as described in principle 1, and the Supervisory Evaluation Process (SEP) as described in principle 2. While the CAAP can utilise advanced risk capital models to produce a single capital outcome, the supervisory framework applies more specific rules for Pillar 1 and Pillar 2 requirements. The CAAP relates to the term "overall capital adequacy" while the SEP relates to "regulatory capital". Economic and regulatory capital may serve different purposes and will have implications for the interaction between the CAAP and the SEP in translating supervisory assessment of all risks into supervisory measures, including the capital requirement.

57. Kredittilsynet and Norges Bank would invite the BCBS to do further work to clarify the concepts of the CAAP and how it interacts with the SEP.

Stress tests

58. The current wording states that the supervisor may wish to review how stress sets have been carried out (paragraph 724). Kredittilsynet and Norges Bank believe that supervisors should be obliged to review stress tests under pillar 2. We would therefore propose the following wording: "*Supervisors shall review how the stress test has been carried out*".

Transparency with respect to individual capital requirements

59. According to paragraph 756, "*Supervisors should make publicly available the criteria to be used in the review of banks' internal capital assessments. If a supervisor chooses to set target or trigger ratios or to set categories of capital in excess of the regulatory minimum, factors that may be considered in doing so should be publicly available*."

60. Kredittilsynet and Norges Bank believe that individual capital requirements set by supervisors should also be made publicly available. When a bank does not provide information about individual capital requirements, the bank will appear to be more solid than

other banks that have no such requirements. In our view, this is not in accordance with the intentions of Pillar 3. Kredittilsynet and Norges Bank observe that this issue is addressed in IASB Update May 2003 (International Accounting Standards Board), which indicates that such disclosure may be made mandatory

Interest rate risk in the banking book

61. The BCBS states that there is considerable heterogeneity between internationally active banks in terms of the nature of the underlying risk and the process for monitoring and managing it. Against this background the Committee considers that interest rate risk in the banking book should be dealt with in Pillar 2. The BCBS nevertheless mentions that an explicit minimum requirement may be relevant provided that the banks are sufficiently homogeneous.

62. Kredittilsynet and Norges Bank refer to the possibility that interest rate risk in the banking book for certain institutions may represent a considerable risk, and that established methods exist for the calculation and monitoring of interest rate risk. For competitive reasons, it is therefore essential to ensure consistent treatment of such risk among the supervisory authorities in various countries. We are therefore of the view that the main rule ought to be that interest rate risk in the banking book should be dealt with under the first pillar, and that only in exceptional cases should it be dealt with in the second pillar. An explicit capital requirement will also reduce the possibilities for arbitrage between the banking book and the trading book.

THE THIRD PILLAR – MARKET DISCIPLINE

63. The Third Pillar of the New Basel Capital Accord consequently provides for a set of disclosure requirements aimed at facilitating the exercise of market discipline and addressing notably the bank's capital structure and capital adequacy and risk exposures. Kredittilsynet and Norges Bank welcome the initiative taken by the Committee to streamline the disclosure requirements in the New Accord.

Interaction with accounting disclosures

64. Kredittilsynet and Norges Bank expect the BCBS to make sure that the disclosure requirements of the New Accord concerning bank capital adequacy do not conflict with disclosure requirements in International Accounting Standards (IAS/IFRS) with which banks must comply from 2005. As mentioned under general observations/accounting rules, it is important to focus on all types of banks, since the EU regulation, to some extent, gives the countries the opportunity to apply different accounting rules to different companies (listed vs unlisted companies, annual vs consolidated accounts). A result of this, different disclosure requirements may apply for unlisted banks etc. from one country to another from 2005. Beyond this, Kredittilsynet and Norges Bank have no objections to the Committee's procedure at this point.

65. If information is not provided with the accounting disclosure, institutions should indicate where the additional information can be found (paragraph 764). Kredittilsynet and Norges Bank recommend that the institutions must disclose where this information can be found.

66. Pillar 3 disclosures will not be required to be audited by an external auditor, unless otherwise required by accounting standards setters, securities regulators or other authorities. Kredittilsynet and Norges Bank suggest that the Committee should consider if it is necessary that banks make it clear that this information is not audited by an external auditor.

Frequency

67. Kredittilsynet and Norges Bank support a requirement that institutions via Pillar 3 have to disclose their capital requirements regularly (paragraph 767). The disclosures set out in Pillar 3 should be made on a semi-annual basis, subject to some exceptions. We have no comments on the qualitative disclosures that might be published on an annual basis. Exceptions are made for "*large internationally active banks and other significant banks (and their significant bank subsidiaries)",* which must disclose their Tier 1 and total capital adequacy ratios, and their components, on a quarterly basis. Kredittilsynet and Norges Bank recommend that this delimitation be made clearer.

CONSEQUENCES FOR THE CAPITAL REQUIREMENT IN NORWEGIAN BANKS

Introduction

68. In co-operation with the Norwegian Financial Services Association and the Norwegian Savings Banks Association, Kredittilsynet and Norges Bank have carried out an impact study based on the Standardised Approach (credit risk) and Basic Indicator Approach (operational risk) on a sample of 15 savings banks and 6 commercial banks. These banks did not participate in QIS3 and are regarded as small and medium-sized banks.

69. The survey is calculated using consolidated data as of 31 December 2002. A presentation of the assumptions underlying the survey is set out in Annex 1.

70. The results show a decrease in capital requirements relative to the current requirements for all the savings banks. On average the reduction is significant. The impact is not as large for the commercial banks although the average figures show a small reduction in overall capital requirements.

Table 1. Overall percentage change in capital requirements

	Average	Max	Min
Savings Banks	**-10**	-5	-17
Commercial Banks	**-1**	7	-20

Summary of Results

71. The participating savings banks account for 37% of total assets among all the Norwegian savings banks and 17% of total assets in the Norwegian banking system. The corresponding figures for the commercial banks are 11% and 6%.

72. The data quality is generally satisfactory. There is, however, some uncertainty regarding the data for the regulatory retail portfolio. Several banks were not able to identify loans to individuals and small businesses and estimates have therefore been made.

73. The portfolio structure of the savings banks is relatively homogeneous. A simple average is therefore applied when summarising the results. The portfolio structure of the commercial banks is less homogeneous and a weighted average is therefore applied.

74. Table 2 illustrates the average portfolio composition. The contributions to change in capital requirements are illustrated in table 3.

Table 2. Portfolio composition

Portfolio	% of exposures	
	Savings Banks	**Commercial Banks**
Corporate	19 %	55 %
Regulatory retail (of which);	15 %	10 %
-Individuals	6 %	5 %
-Small businesses	9 %	5 %
Claims secured by residential property	63 %	34 %
Other portfolios[7]	2 %	2 %
Total	100 %	100 %

Table 3. Contributions to Change in Capital[8]

Exposures	Contribution %	
	Savings Banks	**Commercial Banks**
On balance		
Retail: (of which)	-5 %	-3 %
-individuals	-2 %	-2 %
-small businesses	-3 %	-1 %
Claims secured by residential property	-14 %	-7 %
Past due	0 %	2 %
Off balance		
Commitments under 1 year	1 %	2 %
Other off balance	0 %	0 %
Overall credit risk	-17 %	-6 %
Operational risk	7 %	6 %
Overall change	-10 %	-1 %

75. The capital requirements for **credit risk** show a significant reduction for both savings banks and commercial banks compared with the current Accord. The new **operational risk** requirement does not outweigh the reduction in credit risk capital requirements for the savings banks, which results in a significant overall reduction by 10%. The overall change for the commercial banks is a 1% reduction.

76. The main area of activity where the minimum requirements will change substantially is the retail portfolio and claims secured by residential property, where the risk weights have

[7] Includes interbank exposures, claims on regional governments etc.
[8] The overall change in credit risk requirements does not sum up correctly due to rounding.

been lowered significantly relative to the current Accord. The large contribution reflects the combination of these changes with the importance of retail and residential mortgage portfolios, especially for the savings banks, see also table 2.

77. Past due loans only have an impact on the commercial banks. Other off balance sheet items (including OTC derivatives) do not have an impact on the average results for savings banks or commercial banks, although these are significant factors for some of the participating banks.

78. Note that the risk weights for the corporate portfolio and "other portfolios" are assumed unchanged compared with the current Accord and are therefore not included in table 3, see annex 1 for further explanation.

79. The average increase in the overall capital requirement due to operational risk is 7% for the savings banks and 6% for the commercial banks and shows little variation among the participating banks.

Annex 1. Assumptions – Norwegian survey of the impact on capital requirements for Norwegian Banks

80. Annex 1 describes the assumptions underlying the Norwegian survey.

Credit risk

81. The survey does not calculate the effect of all the elements of the standardised approach, but focuses on elements that are known to have a strong impact on the capital requirement. The survey does not calculate the effect of external ratings (paragraph 27-42) or credit risk mitigation (paragraph 79-179). The survey is therefore limited to paragraph 43-45, 47, 55 and 56.

Retail

82. The definition of retail is identical to the definition in paragraph 44. Regarding the granularity criterion, the 0.2% threshold is applied as a hard limit. In addition, “small business” was defined as businesses with fewer than 20 employees and managed as retail exposures.

Claims secured by residential property

83. The 35% risk weight is applied to loans within a loan-to-value ratio of 80%. Loans above 80% are risk weighted 75% according to the regulatory retail portfolio.

Claims on banks

84. The survey assumes a 20% risk weight for interbank exposures. In Norway this implies the same risk weight as under option 1 (paragraph 37).

Corporate

85. A 100% risk weight is assumed for corporate exposures, as in the current Accord, reflecting the low level of externally rated companies in Norway.

Past due loans

86. To simplify the calculations, a 150% risk weight is applied to past due loans other than claims secured by residential property. The risk weight for claims secured by residential property is 100%.

Commitments

87. A 20% credit conversion factor was applied to commitments with an original maturity up to one year (and a 50% conversion factor for commitments over one year).

Derivatives

88. A 100% risk weight was applied to OTC derivative transactions both in the banking and trading portfolio, which are risk weighted 50% under the current Accord.

Operational risk

89. Gross income is defined according to paragraph 613 and Norwegian accounting rules.