31st July 2003

Basel Committee on Banking Supervision
Bank for International Settlements
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Switzerland

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Dear Sir

THIRD CONSULTATIVE PAPER REGARDING THE NEW CAPITAL ACCORD

Reference is made to the third consultative paper (CP3) regarding the new Capital Accord which was issued in April 2003.

During 2001, the Capital Accord Working Group at the Central Bank of Malta analysed the previous consultative document and submitted its respective comments. However, in January 2002, the function of the Competent Authority responsible for banking regulation and supervision in Malta was transferred from the Central Bank of Malta to the Malta Financial Services Authority (the MFSA). Subsequent to the transfer, a new working group responsible for analysing aspects of the New Capital Accord from the local perspective was established at the MFSA. In this respect, the latter working group has reviewed the documents relating to CP3 and prepared its comments which are attached hereto.

We would point out that due to the limitations of our small jurisdiction and the small size of the banking sector in Malta, our expertise and experience with respect to the Advanced IRB techniques are very limited. Consequently, no comments are being submitted on this area of the Capital Accord.

We hope that our comments can add value to the work that would be carried out by the Committee during this final stage of the Accord.

Yours faithfully

Karol J Gabarretta
Director

Enc.

MFSA

MALTA FINANCIAL SERVICES AUTHORITY

Comments regarding the Third Consultative Paper (CP3) on the Proposed New Capital Accord

PILLAR I – MINIMUM CAPITAL REQUIREMENTS

Credit Risk – *The Standardised Approach*

1. Claims secured by residential property (para. 45)

Exposures secured by residential property are to be risk weighted at 35% if the property is, or will be, occupied by the borrower, or is similarly rented. However, it was noted that during the QIS3 exercise the risk weight of all exposures, towards both retail and corporate counterparties, which were secured by residential property, was decreased from 40% to 35%. In this respect, especially in the case of corporate exposures in small jurisdictions, it could be that a significant portion of residential property utilised as collateral is not directly occupied by the borrowing entity but by a Director of the company or a related party. Therefore, it is suggested that further guidance should be given regarding the risk weight to be applied in such instances.

2. Past Due Loans (para. 48 and 50)

The Authority has positively noted the Committee's proposal to decrease the risk weight of past due loans whose specific provisions exceed 20%. However, as the weighted amount of the loans is already being calculated net of any specific provisions, the remaining portion of the exposure could be receiving a preferential risk weight which would not correctly reflect the standing of the counterparty. Notwithstanding this observation, the local Authority positively recognises that such reduction in the risk weights applied will serve as a further incentive for credit institutions to increase their specific provisions.

In the comments regarding CP2 submitted in May 2001, it was stated that *"in small countries concentration of commercial and residential property as collateral is normal and inevitable. Hence, the application of a 150% risk bucket on the unsecured portion* (in this case neither commercial nor residential property are considered as eligible collateral) *of past due assets could be quite onerous on the banks."* In this respect, the local Authority positively notes the introduction of paragraph 50, which allows the reduction of the risk weight to 100% where the past due facilities are secured by other unrecognised forms of collateral and have specific provisions amounting to more than 15% of the outstanding balance.

Credit Risk – *The Internal Ratings Based Approach*

1. Non significant business units (para. 228)

This paragraph defines non-significant business units as "*immaterial in terms of size and perceived risk profile*". In our opinion this explanation may be open to various interpretations by different entities and thus could hinder the level playing field among different jurisdictions. Although it is acknowledged that it is difficult to set parameters on materiality, it is suggested that the possibility of further guidelines could be explored.

Moreover, the national supervisor is given the discretion to determine whether additional capital should be held under Pillar 2 in respect of these non-significant business units. However, this discretion may seem contradictory as these units were previously defined as being "*immaterial in terms of perceived risk profile*".

2. Parallel calculation for banks adopting the advanced approach (para. 232)

Under the transitional arrangements, credit institutions may be allowed to implement the IRB approach at end 2006 utilising the data based on only the previous 2 years. If these approaches are to be utilised, banks will be required to calculate their capital requirement during the year ***prior*** to the implementation of the New Accord at end 2006. Therefore, some of the credit institutions utilising these approaches, would be required to calculate their requirements during 2006 based on only one year's data. In this respect, the accuracy of the preliminary results would be questionable.

3. Effective Maturity (para. 288 and 290)

The effective maturity period integrated in the formula utilised under the foundation approach is 2.5 years, while if banks are allowed to measure the effective maturity for each facility the maximum allowed is 5 years. In line with the previous comments submitted in May 2001, we note that quite a number of banks have portfolio maturity profiles higher than the period proposed by the Committee.

Operational Risk

1. Gross income (para. 613)

One of the difficulties encountered during the QIS3 exercise regarded the exact definition of gross income. In fact, the Committee issued further clarification, including the fact that the reported figure should be gross of all operating expenses. In this respect, it is suggested that the definition of Gross income in the CP3 should be expanded accordingly.

2. Alternative Standardised Approach (footnote 91)

Under this approach, banks are required to replace the figure of gross income under the retail and commercial business lines with 3.5% of the book value of their respective loans and advances. However, it was noted that, at one point, the footnote states that "*the book value of securities held in the banking book should also be included*", without giving any details regarding where and when this book value is to be included. In this respect, it is felt that further clarification regarding this issue is required.

PILLAR II – SUPERVISORY REVIEW PROCESS

1. Interest Rate Risk in the Banking Book (para. 720)

In this respect, we refer to the previous comment submitted in 2001. As no specific capital charge has been established in respect of interest rate risk under Pillar I, different jurisdictions may be able to treat the matter differently. In fact, para 720 states that supervisors may even establish a mandatory minimum capital requirement under their jurisdiction. These divergences may hinder the level playing field among different jurisdictions.

PILLAR III – MARKET DISCIPLINE

1. Appropriate Disclosure (para. 760)

It is noted that supervisors are given the discretion to make *some* or *all* of the information provided by the banks publicly available. In this respect, it is felt that, for consistency's sake, definite guidelines should be provided to all supervisors.

2. Bank Disclosures (para. 764)

It is noted that where disclosures are not mandatory under accounting requirements, credit institutions are free to choose any means which they wish to utilise for their disclosures. Although, it is acknowledged that it is difficult to establish one standard method for all credit institutions, this would facilitate tracing of data disclosed by different institutions and in different jurisdictions.

3. Proprietary Data (para. 768)

Where certain data which is to be disclosed is proprietary or confidential in nature, credit institutions may be exempt from the disclosure requirements. In this respect, it should be noted that as small economies only have few large corporations in particular sectors most credit risk data relating to past due facilities *(as per Table 4 and 5 on pages 160 and 161)* may be considered proprietary.

Capital Accord Working Group
Banking Unit

31st July 2003