THE NORWEGIAN
SAVINGS BANKS ASSOCIATION

Kredittilsynet

Postboks 100 Bryn
0611 Oslo

Your ref.: 200303560 Our ref.: 200000157 Oslo 03.07.2003

Submission on the proposal for a new capital adequacy framework

Reference is made to Kredittilsynet's letter of 30 April 2003 requesting the comments of the Norwegian Savings Banks Association on the Basel Committee's proposed new guidelines for calculating banks' capital adequacy.

1. General comments

- This round of consultation is the third since the Basel Committee presented its initial proposal for a new capital adequacy framework in June 1999. Although the Basel Accord is basically designed to apply to large international banks within the G-10 area, the standard is today undeniably being employed with great success to regulate the financial soundness of banks of varying size and complexity worldwide. The proposed framework implies, in contrary to current regulation, to large degree flexibility both for banks and supervisors. In our view the central premise for the review process should be to retain the Basel Accord as a harmonised standard for banks of varying size.

- In the Association's view the present draft is an improvement on the original drafts in some important respects. First, it is better geared to small and medium-size banks. This is specifically reflected in lower weighting for loans to the retail market, both under the standardised approach and the internal rating-based approach, and in the fact that IRB is now available to a wider group of banks. Hence it is more likely that the aim of changing the rules – i.e. to ensure that capital requirements more closely reflect loan risk – will be achieved.

- The Basel Accord needs to be revised to accommodate differences in risk between and within asset classes. In the Association's view there is nevertheless reason to raise questions on how far supervisory authorities should go in permitting use of internal risk measurement systems for calculating minimum capital requirements. The use of such systems should be viewed along two dimensions; for internal risk management purpose and for calculating minimum capital requirement. In relation to the first dimension, it is of course very important that banks develop and improve their own risk management systems for better to estimate the own risk. This will give the banks positive effects in the capital markets as well as in relation to external ratings. Concerning the other dimension, the Association agrees that the regulation should contain incentives for banks to develop and make use of internal systems, but that the Basel Committee go too far in permitting the use of the most advanced methods for calculating the capital requirement. We have in mind the most advanced method of calculating the measurement base for credit risk (advanced IRB approach) and the most advanced method for calculating capital requirements for operational risk (advanced measurement approach). We do not consider it appropriate that an absolutely central governmental regulation with, among other, a bearing on how ordinary depositors invest their funds should be so wide-ranging and complicated that only a minority of specialists in banks and officialdom are in a position to gain a full overview of the rules and of the computation of the individual bank's capital requirement. It may also be queried whether the management boards of banks that apply such methods are realistically in a position to do the job required of them under Pillar 2. We are thus of the opinion that only the standard method and the foundation IRB approach should be allowed for calculating capital requirement for credit risk and only the basic indicator and the standardised approach for operational risk.

- An express objective of the previous consultation document of January 2001 was that the Capital Accord should continue to promote uniform competitive conditions. This objective is toned down in the present proposal. In the Association's view the present proposal will not promote the creation of equal competitive conditions between banks and between countries, and we regard this as detrimental. This is partly because the Basel Accord has switched from common rules applying to all banks to a series of options offering a choice to national supervisory authorities and to the individual bank. In our view this absence of harmonisation could lead to an overall impairment of the banking system's financial strength since national requirements will tend to converge with the rules of the most liberal countries due to pressure from the industry (supervisory arbitrage). Furthermore, apart from the first two years there will no longer be a floor in effect to limit reductions of the capital requirement for banks which employ internal rating. This said, the competitive advantages for banks employing internal rating are reduced due to relaxed risk-weighting rules under the standardised approach.

- We also note the Basel Committee's view that banks employing the standardised approach will, when capital requirements for operational risk are taken into account, on average face an unchanged capital requirement. This is a sensible conclusion in our view. The original proposal - which entailed that banks wishing to employ internal rating to calculate their measurement base for credit risk would on average achieve a reduction of the capital requirement at the same time as the banking system's aggregate capital base would be maintained - necessarily meant that the reductions would be "financed" by banks employing the standardised approach. In the Association's view this was unacceptable a) because banks utilising the standardised approach lend almost exclusively for retail purposes, implying a lower risk profile than in the case of banks lending mainly to corporates, and b) because these banks constitute a negligible threat to financial stability. The Savings Banks Association would nevertheless point out that on-average unchanged capital requirements for banks employing the standardised approach would, along with the discount planned for banks employing internal rating, entail lower capital requirements for the banking system overall.

- Based on the need to be able to compare banks and to ensure some degree of competitive equality, we believe that all banks should disclose, on an annual basis, their capital adequacy ratios based on the standardised approach and either of the two simplest methods for computing the capital requirement for operational risk.

Scope of Application

- Point 2 in the chapter on Scope of Application states that “the Accord will be extended to include, on a fully consolidated basis, any holding company that is the parent entity within a banking group to ensure it captures the risk of the whole banking group”. The Savings Banks Association agrees that the rules should also encompass holding companies.

- “Banking groups” are defined as “groups that engage predominantly in banking activities”. In our view the term “predominantly” needs further clarification.

- The enclosed diagram, which illustrates the scope of application, and the wording of point 4 of the same chapter to the effect that “supervisors should <u>test</u> (our underlining) that individual banks are adequately capitalised on a stand-alone basis”, fails to clarify whether the rules also apply on a stand-alone basis or only on a partially consolidated and consolidated basis.

  Point 4 states that one of the principle objectives of supervision is the protection of depositors. It also states that “it is essential to ensure that capital recognised in capital adequacy measures <u>is readily available</u> for those depositors” (our underlining). In the view of the Association this is an absolutely central justification for applying the capital adequacy rules on a stand-alone basis too.

3. The First Pillar

3.1 The standardised approach

- The Savings Banks Association supports the proposal to introduce further risk classes under the standardised approach. This will help to ensure a more correct linkage between credit risk and capital requirements.

- The reduction in the weighting of the best residential mortgage loans to 35% is in the Savings Banks Association’s view appropriate from the credit risk angle. Losses on residential mortgage loans are low historically speaking. We have greater doubts about the merits of assigning a weight of 75% to the remaining retail portfolio. However, the Association does not oppose this proposal.

- The Basel Committee has chosen to maintain its original proposal regarding for two alternative methods of weighting claims on banks. The Savings Banks Association would point out that this may lead to differing treatment of the same type of asset in different countries. The Association continues to prefer the method that weights banks one class higher than the weight assigned to the bank's home state, based on the view that there is a close link between a country's economy and the development of its banks and the fact that external rating is rare in small countries with many small and medium-size banks.

- Where credit risk on loans secured by commercial real estate is concerned, the Association agrees that such lending has historically accounted for a substantial share of banks' aggregate loans. Loans secured by commercial real estate represent a substantial business area for Norwegian banks, and currently make up about 30% of lending for commercial purposes and 12% of total lending. However, commercial property lending is by no means a homogeneous category, spanning as it does a wide range of borrower risk. In fact for banks whose exposure is low compared with the value of the properties in question and/or which have established long-term contracts with lessees who are unlikely to default, such lending represents low risk. In our view this risk disparity, as in the case of other assets, calls for differentiated risk weighting. We have in mind weightings ranging from 40% to 150% based on objective condition of the risks.

- Where credit risk mitigation is concerned, the Savings Banks Association is of the view that the proposal inadequately recognises the value of physical collateral as a risk mitigant. In principle only well-secured residential loans on specific terms achieve reduced weighting, along with – exceptionally - loans on commercial real estate. The proposal is however highly detailed, and relatively demanding solutions (haircuts etc.) are recommended in regard to financial collateral; this appears to excessively reflect the activity of major international investment banks and to inadequately reflect the activity of more traditional banks where physical collateral is the usual means for mitigating credit risk. In addition to calling for other types of physical collateral to qualify for capital reductions, the Savings Banks Association holds that a change should be made in the conditions imposed for residential loans to qualify for a weighting of 35%. In our view the conditions should be formulated with a view to ensuring conservative valuations and to taking into account the property's realisability instead of focusing on whether or not the borrower lives in the residence.

3.2 The internal ratings-based approach

Important changes have been made to ease access to use of internal rating, as a result of which this method will be of interest to a larger number of banks than the Basel Committee originally envisaged.

Roll out rules (par. 226-227). The proposed rules will lend flexibility to banks which, within a certain period, wish to move certain asset classes and business lines from the standardised approach to IRB.

The right to permanent partial use (par. 228) of non-material asset classes and business lines. This enables capital requirements for such exposures to be calculated on a permanent basis using the standardised approach even though the bank applies the IRB approach to calculate the requirements for other asset classes.

The Savings Banks Association supports both the above changes. Where roll out rules are concerned the Association agrees with the Basel Committee that the object of these rules should be to encourage banks to switch to more sophisticated management methods, and not be motivated by a desire to reduce their capital ratios.

3.3 Capital requirements for operational risk

The Savings Banks Association agrees that operational risk is a central risk in the business of banking. We nonetheless believe that it is not appropriate to impose on banks a capital requirement to cover this risk so long as well-established quantification methods are unavailable. In our view neither the Basic Indicator nor the somewhat more advanced Standardised Approach adequately expresses the operational risk inherent in banking business.

There is reason to assume that there is a link between the infrastructure within which banks operate and operational risk. There is probably wide variation between countries in this area.

Until better methods are developed the Association believes that control of operational risk is best achieved as a part of the review to be undertaken by national authorities in connection with Pillar 2 which will include a through, overall review of the relationship between financial soundness and risk.

4 The Second Pillar

- The Norwegian Savings Banks Association believes that the proposed four central principles together with the Basel Committee's Core Principles for Effective Banking Supervision of 1997 and Core Principles Methodology of 1999 together constitute a sound approach to Pillar 2.

- In our view the introduction of a supervisory review process as a central aspect of capital adequacy regulation raises fundamental issues. One such issue is the division of work and responsibilities between supervisory authorities and the individual bank's board and senior management. The current Basel Accord merely distinguishes between a bank's fulfilment of the 8% requirement and non-fulfilment of the requirement. Pillar 2 imposes tasks and obligations on the supervisory authorities even in situations where a bank meets the statutory minimum requirement. The supervisory authorities are required to take action if, say, they consider a bank's risk management to be inadequate, if its capital ratio is deteriorating, if it is overly exposed to a small number of large commitments or the like. Another new feature is requirements on bank boards and senior managements when it comes to determining and monitoring risk and capitalisation.

- The very principle of empowering supervisory authorities to intervene in a situation where a bank is in compliance with the statutory minimum capital requirement is far from unproblematic since roles and responsibilities will tend to become confused. The Norwegian Savings Banks Association believes it to be an absolutely fundamental principle that a bank's board and senior management are responsible for operations by virtue of, among other things, their responsibility for risk management. Paragraph 704 contains an important amplification in relation to the previous proposal. This paragraph opens with a reference to risk areas that supervisory authorities should review on a regular basis. It goes on to make clear that "The emphasis of the review should be on the quality of the bank's risk management and controls and should not result in supervisors functioning as bank managers." The Association fully supports this amplification.

- The proposed Pillar 2 appears to be designed with a view to supervision of large banks. We agree that the significance of the large banks in terms of financial stability calls for close supervisory attention. On the other hand there is little to suggest that small and medium-size banks whose capital adequacy far exceeds the minimum requirement should be subject to the same, and equally frequent, on-site control. These banks will off course be subject to the same requirements as large banks when it comes to off-site supervision such as reporting etc. There is also reason to presume that many of these banks will have problems meeting the requirements imposed by this Pillar. This emerges for example in the point concerning internal control reviews. The Association believes for this reason that differentiation based on bank size should be applied to a greater degree when concrete tasks are drawn up under the proposed four key principles.

- The Savings Banks Association agree with the proposal in paragraph 682 that the supervisory authorities should when carrying out the review under Pillar 2 assess risk areas that are not, or are only partially, covered by the capital adequacy requirements. Relevant risk areas in this context are interest rate risk in the banking portfolio, liquidity risk, risk posed by large exposures and concentration risk.

- As regards the issue of publishing the capital requirements set for an individual bank, paragraph 765 states the "Supervisors should make publicly available the criteria to be used in the review of a bank's 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."

  In the view of the Norwegian Savings Banks Association this is a sensible solution. Publication of orders setting capital requirements in excess of the regulatory minimum, which has been considered at an earlier stage, is problematic since it could lead to a run on the bank by depositors. Even professional investors may cut credit lines, potentially leaving the bank with an acute lack of funding.

5. The Third Pillar

- Pillar 3 is designed to complement the other two Pillars. The Basel Committee envisages that requiring banks to disclose key risk information will encourage market discipline.

  The thinking behind heightened disclosure and transparency requirements is in evidence in other international arenas. Changes in the international accounting standard (IAS) will lead to new comprehensive requirements as to the information contained in notes to financial statements. The introduction in the EU of the Prospectus Directive and the forthcoming Transparency Directive will similarly raise disclosure requirements.

The Savings Banks Association would point out that requirements contained in the various bodies of rules will, overall, entail substantial additional work for the banks. Hence it is important to harmonise the requirements of the revised Basel Accord with requirements imposed in other relevant bodies of rules so as to avoid the same type of information being presented in a variety of different ways.

- Where reporting frequency is concerned, it is proposed that the disclosures set out in Pillar 3 should be made on a semi-annual basis with the exception of qualitative disclosures which may be published on an annual basis. Core capital ratios, capital ratios, including capital base elements, must be disclosed on a quarterly basis. The Association has no objections to this proposal.

- Chapter 3 table 2 contains disclosure requirements referring to capital structure. In our view provision should be made under (c) for disclosure of the relative proportions of banks' upper Tier 2 capital and lower Tier 2 capital.

- Paragraph 774, table 4, (c) and (d), requires disclosure of credit exposures broken down by industry, geographical distribution and type. The Norwegian Savings Banks Association's view is that the Basel Committee goes too far here in requiring banks, in effect, to expose customer relationships, which is problematic in a competitive perspective. This will particularly apply in the case of small and medium-size banks where the proportion of business sector loans is low.

- The same paragraph, table 8, requires quantitative and qualitative disclosures of the portion of each individual credit portfolio that is covered by financial collateral (before the application of haircuts). It similarly requires disclosures of the portion of each portfolio that is covered by guarantees and credit derivatives. The Norwegian Savings Banks Association believes the complying with this requirement will, in purely practical terms, be a very demanding task for banks.

Yours sincerely

The Norwegian Savings Banks Association

Arne Hyttnes
Managing Director

Erik Johansen
Assistant Director