Polish banking supervisory authority
COMMISSION FOR
BANKINIG
SUPERVISION

COMMENTS
on the Third Consultative Document
“The New Basel Capital Accord”
issued by the Basel Committee on Banking Supervision

If not stated otherwise, numbers of provisions quoted in the text refer to the main consultative document “The New Basel Capital Accord” (the Consultative Document)

GENERAL COMMENTS

1) **The overall direction of the changes undertaken in “The New Basel Capital Accord” is considered by the CBS to be a very positive development.** It constitutes an attempt to account for the progress observed in the international banking system after the implementation of “The Basel Capital Accord” of 1988 (especially in the field of banking activity globalization). The third consultative document introduces a bunch of changes in relation to its second version, published in 2001. However, CBS regrets noting, that the **modifications do not address all the reservations** expressed by the Commission for Banking Supervision in the former comments. These were, as follows:
   a) New Capital Accord treats unfavorably countries carrying out systemic transformation, such as Poland, Czech Republic and Hungary (replacement of the OECD-membership criterion by ECAI rating while assigning country risk weight),
   b) proposed approach may result in fostering the division into highly developed and underdeveloped banking systems, both with respect to external funding and capital costs,
   c) proposals for credit risk measurement, even in their simplified versions, are excessively complex,
   d) risk sensitive approaches of the New Capital Accord may produce the excessive pro-cyclical effects,
   e) doubts over practical application (reliability and penetration) of ECAI ratings in corporate portfolios still remain valid.
2) Despite of the above, **Commission for Banking Supervision highly appreciates the progress made since CP 2 and QIS 3** especially in the area of calibration and fine-tuning of the proposals and welcomes the generally increased level of flexibility of the solutions provided. CBS appraises positively such developments as:
   a) **increased accuracy of IRB** approaches (separate risk weight curves for sub-portfolios, correlation, firm-size adjustment, recognition of FMI),

b) **increased flexibility in operational risk** area (ASA, partial AMA, recognition of insurance),

c) **calibration of SA** (SME risk weight – 75%, residential mortgage risk weight – 35%).

d) **recognition of specific provisions under SA**,

e) **reduced severity of Pillar 3 requirements**.

SPECIFIC COMMENTS

Commission for Banking Supervision would like to encourage Basel Commitee on Banking Supervision to re-consider the following issues:

1. **recognition of physical collateral under Standardised Approach,**
2. **adoption of permanent partial use under IRB approach,**
3. **further recognition of specific provisions under IRB approach,**
4. **unification of the treatment of guarantees / credit derivatives and financial collateral as CRM techniques,**
5. **unification of CCF under SA and FIRB approaches,**
6. **re-calibration of BIA and SA (operational risk),**
7. **increase the level of descriptiveness of Pillar 2 requirements,**
8. **decrease the scope of application of Pillar 2 requirements.**

Ad. 1. **recognition of physical collateral under Standardised Approach**

CBS highly appreciated the move that had imported certain way of thinking from IRB to Standardised Approach – namely the recognition of specific provisions. However CBS thinks that one step further should be made. CBS does not see any serious obstacles to use the framework proposed in par. 264, 265 (with the replacement of lowered LGD by lowered risk weight) not only under FIRB but also under Standardised Approach for collateral that meets the criteria set out in par. 472 – 487.

If the issue of the calibration of relative burden of FIRB versus SA is a concern – CBS believes that it should not be solved by wiping out the ability to treat physical collateral as a credit risk mitigant under SA.

Ad. 2. **adoption of permanent partial use under IRB approach**

Allowance for the partial adoption of AMA is a clear sign, that fully comprehensive attitude to the more sophisticated methods of risk calculation is an effort which is not always worth undertaking. So CBS suggests extending this philosophy to IRB approaches. Exposures in certain portfolios (bank, sovereign) are usually very difficult to be allocated according to their PD's (data limitation). From the other hand, the high level of external rating penetration in these portfolios considerably decreases the possibility of regulatory arbitrage made by leaving out such exposures from IRB treatment. CBS believes that conditional permission (at national discretion and on case-by-case basis) of permanent partial use of FIRB with the exclusion of the entire (to avoid "cherry picking")

sovereign and bank portfolios (still treated under SA) creates a good balance between accuracy and practicality of the proposed solution.

Ad. 3. **further recognition of specific provisions under IRB approach**

For non-defaulted assets, any amount of specific provisions and partial write-offs that exceeds the EL capital charge for the underlying exposures may not be used to cover any other capital charges (par. 346).

Specific provisions are very often created not due to the banks' internal credit risk assessment but because of some external requirements (e. g. accounting related issues - taxation), and they often do not trigger default and have little in common with the level of EL.

Regardless of the formal status (defaulted – non-defaulted) of the loan, the specific provisions (or portfolio-specific general provisions) represent funds set aside from income (and capital) and they are designated to cover credit losses.

Such characteristic of this item empowers to treat specific provisions (or portfolio-specific general provisions) as a part of capital (at least in the credit risk area for a given portfolio).

Ad. 4. **unification of the treatment of guarantees / credit derivatives and financial collateral as CRM techniques**

Proposed framework puts in more favorable position holders of eligible financial collateral against parties secured by guarantees or credit derivatives of the same creditworthiness.

Uneven treatment of eligible financial collateral and guarantees / credit derivatives can be seen in two dimensions:

1. range of eligible entities as protection providers (in the case of eligible financial collateral – issuer, in the case of guarantee / credit derivative – guarantor / protection seller).

   Example - in the case of non-bank entity, the threshold rating is BBB- for eligible financial collateral and A- for a guarantor/protection seller.

2. calculation of capital charge. Substitution of risk weights (the only option relevant to guarantees / credit derivatives) is much more conservative than calculation of adjusted exposure (comprehensive approach allowed for eligible financial collateral).

   Example - to get 0% capital charge on exposure, a bank has to:

   a) get a state (sovereign) guarantee - in the case of guarantee / credit derivative,

   b) get some level of over-collateralisation with no-high quality papers (BBB-) – in the case of comprehensive approach for eligible financial collateral.

CBS does not think that assumed higher level of liquidity of protection in the form of eligible financial collateral is sufficient explanation to the difference in the way of treatment of the two major types of CRM techniques.

Ad. 5. **unification of CCF under SA and FIRB approaches**

Difference between CCF for commitments under Standardised (20%, 50%) and FIRB Approaches (75%) is not clearly justified.

Ad. 6. **re-calibration of BIA and SA (operational risk)**

CBS thinks that calibration of B and α parameters should be subject to further scrutiny:

1. Relative burden of BIA against SA does not give any incentive for banks to move toward more sophisticated method.
2. QIS 3 results can suggest that internal distribution of capital charges within SA may be biased towards penalizing traditional banking activities (retail and commercial banking). CBS thinks that proposed volume-based factor (ASA) is not the only solution to this problem, the second one could be the re-calibration of the *Betas.*

The problem of variability in the margin levels in traditional banking across banks located in different countries should also be investigated further. Apart from the explanation given by the Basel Committee (double counting of credit risk), one can imagine some other reasoning:

1. High margins may not be only an indicator of high risk (credit plus operational) but they can also be the way to absorb high EL via current income rather than through capital or provisions. Because there is a difference in relative importance of EL against UL between traditional banking and more sophisticated banking activities (traditional – relatively high EL, low UL; others – opposite relation), the consequent discrepancy in the margin levels in the two classes of activities may be carried on.

   This would lead us to the treatment of operational risk in the traditional banking like a credit risk in the case of QRE (partial offset due to FMI).
2. Additionally in less competitive banking systems high margins in traditional banking may be also cost-driven ("gross income" does not take into account operational expenses).

Ad. 7. **increase the level of descriptiveness of Pillar 2 requirements**

Principle 3 of Pillar 2 may be interpreted in many ways by different supervisors. This may lead to unleveled playing field and regulatory arbitrage. Expressions used in Pillar 2 language ("supervisors will typically require (or encourage) banks") sound very ambiguously. The further guidelines in the form of the best supervisory practices and minimum requirements should be worked out and published as soon as possible.

The wording of Pillar two should be more precise in the description of types of risk, which should be addressed through supervisory review process (especially in the context of additional capital charges). Even if we had the common understanding of the scope of risks that should be subject to principle 3 treatment, we would still need a common confidence level to ensure the same level of required capital. That was done in Pillar 2 only in the case of interest rate risk in the banking book. CBS suggests application of such type of attitude towards other types of risks.

Ad. 8. **decrease the scope of application of pillar 2 requirements**

Requirements stated in principle 1 & 2 of Pillar 2 concerning banks' internal capital adequacy assessments and strategies seem to impose an excessive burden (financial, human resources) on our smallest co-operative banks and they do not offer any considerable value added for them. CBS would need a clear statement that scope of application of Pillar 2 requirements is subject to national supervisory discretion based on cost – benefit analysis.