SOUTH AFRICAN RESERVE BANK

FROM THE OFFICE OF
THE REGISTRAR OF BANKS

CONFIDENTIAL

2003-07-31

The Chairperson
Basel Committee on Banking Supervision

Dear Sir

COMMENTS ON THIRD CONSULTATIVE PAPER OF NEW CAPITAL ACCORD

This Office, under the auspices of the South African Reserve Bank, wishes to congratulate the Basel Committee on Banking Supervision on its efforts to finalise the New Accord and in particular, on taking the interests of countries that are not members of the Group of 10 into account.

We wish to thank the Committee for affording us an opportunity to comment on the third consultative paper of the proposed New Accord. Our comments, which incorporate comments raised by the banks under our supervision, are attached hereto.

We wish you the best of luck in the last round towards the finalisation of the New Accord.

Yours faithfully

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BANK SUPERVISION DEPARTMENT

South African Reserve Bank

Submission to the Basel Committee on Banking Supervision

On

The Third Consultative Document
of the New Basel Capital Accord

28 July 2003

INTRODUCTION

1. The Bank Supervision Department (“BSD”), under the auspices of the South African Reserve Bank (“SARB”), welcomes the opportunity to comment on the third consultative document ("CP3") on the New Capital Accord.

2. In drafting the comments on CP3, the BSD followed a consultative approach. Accordingly, apart from expressing the views of the BSD, this paper incorporates the comments of banks (local and foreign) operating within South Africa. This paper, therefore, represents the views of the South African banking sector.

3. Although the banks’ comments have been incorporated into this paper, the banks were not restricted from commenting individually on CP3.

4. The BSD wishes to congratulate the Basel Committee on banking Supervision ("the Committee") on the progress made with finalising the Accord and on taking the interests of countries that are not members of the Group of Ten ("non-G10 countries") into account. Many of the issues raised by non-G10 countries appear to have been incorporated into CP3.

5. We agree with the fundamental principles and structure of the proposals. We support the three pillars and the different approach to the calculation of capital adequacy arising from credit, market and operational risk. The comments below merely point out calibration issues and, in some instances, seek further guidance from the Committee.

6. This paper sets out general comments on CP3, followed by identification of pertinent issues relevant specifically to emerging markets. Lastly, this paper comments on specific technical issues, in respect of which further guidance is sought from the Committee.

GENERAL COMMENTS

7. The BSD wishes to confirm and maintain the position set out in its comments on the second consultative paper, submitted to the Committee in May 2001, namely, that the BSD supports the introduction of:

   a. The three mutually reinforcing pillars, namely, minimum capital requirements, the supervisory review process and market discipline, and the principles contained therein.

   b. The more risk-sensitive menu of approaches to determine minimum capital requirements for banks.

   c. Incentives to promote sound risk-management practices in banks.

8. Furthermore, the BSD endorses an improved capital-adequacy framework that is intended to foster a strong emphasis on risk management and to encourage ongoing improvements in banks' risk-management capabilities. Improved risk management in banks has the potential to enhance the safety and soundness of a country's banking and financial system.

9. In the development of the 1988 Accord and the proposed New Accord, the Committee has focused on internationally active banks being regulated in member countries. That said, over one hundred countries across both G10 and non-G10 countries have adopted the 1988 Accord as international best practice, and are desirous of updating the old capital-adequacy framework by means of the New Accord. In recognition of the wide acceptance of the best practice capital-adequacy framework, the Committee has sought to protect the interest of not only member countries, but also non-member countries. In this regard, the BSD applauds the creation of the Core Principles Liaison Group, including the Working Group on Capital, to safeguard the interests of non-G10 countries. The BSD wishes to thank the Committee for affording South Africa member status of the Group. The Committee's work with non-G10 countries has culminated in a proposed accord suitable for application in banks and by supervisors not only within G10 countries, but also in non-G10 countries.

10. The third Quantitative Impact Study ("QIS 3") had by far the largest number of participants from non-G10 and non-European Union ("non-EU") countries, namely, 111 banks from 18 countries. The findings clearly demonstrate, on average, the increased capital requirements for non-G10, non-EU countries. The Committee's objective of at least maintaining the current overall level of capital in the system appears not to have been met for this group of countries. Given the logistical complexities of the QIS 3 exercise, and the fact that banks provided the information on a best-effort basis, inconsistencies may be inevitable, and conclusions can be drawn only subsequent to a multitude of such studies.

11. QIS 3 points to a need for further impact studies to be conducted in non-G10 countries, so as to ensure that the new Accord is implemented without unintended consequences arising, and to develop implementation plans that support the Committee's objectives. In this regard, the BSD, in consultation with the South African banking sector, considers it necessary continually to focus on the economic impact of the New Accord during the implementation phase until the end of 2006. To this end, we have established an Economic Impact Subcommittee under our Accord Implementation Forum, which engages the banking sector on implementation issues.

12. The need for further impact studies in no way detract from the BSD's commitment to the implementation of the New Accord. To this end, the BSD and the banks that it regulates, are endeavouring to implement the New Accord no later than is required by the members of the Committee. Implementation, however, will have to be undertaken from the perspective of an emerging economy. A prudent approach will further ensure the development of a safe and sound financial system, which is the paramount objective of the New Accord.

GENERAL ISSUES

Incentive Compatibility

13. One of the Committee's objectives is that minimum capital requirements remain broadly unchanged for large internationally active banks, account being taken of the fact that they are likely to use the internal-ratings based ("IRB") approaches. The proposals would offer an incentive for internationally active banks to adopt the more sophisticated IRB approaches. Indeed, QIS 3 revealed a reduction of 2 per cent in capital requirements for G10 banks and a 6 per cent reduction in capital requirements for EU banks, using the advanced IRB approach.

14. For non-G10, non-EU countries, there was an overall increase in capital requirements of 12 per cent for the standardised approach and 4 per cent for the foundation IRB approach. Some of the reasons cited for the increased capital requirements are:

    a. All results were thought to be somewhat overstated, one of the reasons being difficulties experienced in identifying new forms of collateral.

    b. Data quality may not have been as good as expected, since the QIS 3 exercise was done on a best-effort basis.

    c. There was a general lack of credit-risk mitigation data.

15. The above reasons presume that, as banks progress towards full implementation, better data will reflect reality, which may result in an incentive that is compatible to the new capital-adequacy framework. Undoubtedly, further impact studies are required at an individual country level, as stated above.

16. Other reasons cited for the increase in capital requirements for non-G10, non-EU countries, however, pointed to calibrations in the proposals that may not favour such countries. Some of the reasons include:

    a. A significant contribution to the increase in requirements in the standardised approach was due to the treatment of sovereign exposures. The increase can directly be attributed to the proposed removal of the "club approach" of the Organisation for Economic Co-operation and Development and capital requirements being related to the inherent risk of the sovereign.

b. The additional operational-risk charge was, on average, a large contributor to the overall increase in capital requirements for non-G10, non-EU countries. The increase in capital requirements due to operational risk were not offset by a corresponding decrease in capital requirements for credit risk. Indeed, QIS 3 results for non-G10, non-EU countries showed that there was an average increase of 3,82 per cent in the contribution of credit risk to the overall change in the standardised approach, whereas the contribution for operational risk increased by 15,07 per cent on average.

c. A conclusion drawn from the analysis of non-G10, non-EU results generally point to a tendency for the operational-risk charge to be higher for banks in countries with lower sovereign ratings than in countries with better sovereign ratings. For a bank to remain in business, its gross margins must cover not only overheads and other operating costs, but also its expected credit costs and remunerate capital set aside to cover unexpected losses. This introduces an element of double counting into the proposals. In essence, higher risk business results in higher margins as a means for compensating the higher risk taken. The higher margins, in turn, increase gross income, which increases the operational-risk charge. This problem is partly solved for Group 2 banks, by the introduction of the volume-based alternative standardised approach to operational risk.

17. In essence, the above suggests two reasons for the increase in the overall capital requirements for non-G10, non-EU country banks. Firstly, inconsistencies due to a lack of information may show varying results. As banks progress towards implementation, a more accurate picture will start to emerge, and this might meet the incentive compatibility objective. Secondly, and more importantly, the increased capital requirements reflect the emerging-market status of the non-G10, non-EU participants. It can therefore be concluded that the higher perceived risks in emerging markets will require higher capital-adequacy levels. Recalibration of the New Accord for local market conditions will be a contradiction of the philosophy of a risk-sensitive capital-adequacy framework applicable to internationally active

banks. Further, such intervention might create unlevel playing-fields, potentially resulting in unintended consequences, which might have a negative impact on financial stability.

18. If the latter argument indeed proves to be true, the BSD requests the Committee to provide guidance to foster incentive compatibility for internationally active banks adopting the more advanced approaches to capital-adequacy calculations in emerging non-G10 countries. For the South African banking sector, this is even more pertinent, since the majority of banks have indicated their preference for the adoption of the IRB approach to credit risk. A lack of appropriate incentives will hamper implementation initiatives and poses a danger that the Committee's objectives of improving risk-management standards not being met. The BSD would suggest that the Accord Implementation Group, together with the Core Principles Liaison Group, investigate this issue and provide suitable guidelines to emerging-market regulators.

Cost, Benefit and Complexity

19. Since the establishment of the 1988 Accord, banking has become a complex business. The Committee has on several occasions explained the complexities inherent in the proposals by referring to complexities inherent in the business of banking today. The Committee has stated that complex problems require complex solutions. The Committee further claims merely to have captured the evolutionary improvement in the way in which banks measure and manage risk. In essence, the Committee's aim is to narrow the gap between economic- and regulatory-capital allocation methods.

20. The complexities, however, translate into higher costs for banks adopting the more advanced approaches.

21. Based on the comments above, as well as the QIS 3 results for G10 and non-G10 countries, the apparent cost of implementation may not be balanced by an equivalent reduction in the capital charge (the incentive). Banks in developed

markets are claiming to budget between US$1 million to US$150 million for the implementation of the New Accord by December 2006. It is unclear whether an equivalent benefit is derived by adoption of the more sophisticated approaches of the proposals for the New Accord. If the incentive compatibility argument raised above is indeed proved to be true, South African banks will derive only marginal benefits, whilst having to spend multiples of the benefits derived.

22. Equally, the proposals for the New Accord place significant resource requirements on regulators, who will have to redesign their processes to move from a "one-size-fits-all" approach to a customised supervisory approach.

23. The lack of implementation guidelines further adds to costs, as banks and regulators seek to find the best and most effective processes through trial and error. Greater certainty could somewhat reduce the cost of implementation. The BSD, accordingly, recommends that the Accord Implementation Group, together with the Core Principles Liaison Group, develop implementation guidelines that will reduce some uncertainties in the process. For example, it would be useful to regulators and banks if guidelines were developed on the process of approving and validating credit-risk and operational-risk models. Guidelines will also ensure a level of standardisation, which will contribute to the creation of a more level playing-field, where arbitrage opportunities are minimal. In addition, the Accord Implementation Group should devise means to foster a closer working relationship between the regulators of different countries.

STANDARDISED APPROACH

Foreign-currency Rating versus Domestic-currency Rating

24. Market forces have led to the development of a two-tier rating system, namely, foreign-currency and domestic-currency ratings. The principles put forward by the Committee are that exposures denominated in domestic currency, when the counterparties conclude their transactions within the domestic jurisdiction, should not incorporate currency or country risk, and, therefore, the domestic-currency ratings are appropriate. Conversely, exposures in foreign currency and when transactions are conducted cross border should incorporate currency and country risk. In that case, the foreign-currency ratings would be appropriate.

25. The BSD is of the view that the Committee has encompassed the above principles in the proposals, in the form of paragraph 72 of CP3. Paragraph 72, however, appears to be applicable only to unrated exposures that are risk weighted based on the rating of an equivalent exposure to that borrower.

26. The BSD requires further clarity on the intentions of the Committee. The BSD maintains the view that all exposures originating within the domestic jurisdiction and funded and lent out in domestic currency should qualify for a domestic-currency rating. In such a case, if a bank has obtained a rating for the issue or the issuer, and the appropriate external credit-assessment institution meets the eligibility criteria, as determined by the national supervisor, then the bank should be allowed to risk weight the exposure as a rated exposure, and the domestic-currency ratings should be applicable.

27. Clarity on this issue is crucial, since it will have a significant impact on capital requirements of those banks adopting the standardised approach. In practice, foreign-currency ratings impose a sovereign ceiling. If the foreign-currency ratings were to apply to domestically originated transactions, funded and lent out in domestic currency, many highly rated emerging-market corporates may be rated

as non-investment grade, requiring additional capital requirements to be held by the bank originating the exposure.

Calibration Issues - Commitments

28. Under the standardised approach, commitments with an original maturity of up to one year and commitments with an original maturity of over one year will receive a credit conversion factor (CCF) of 20 per cent and 50 per cent.

29. Under the foundation IRB approach, a CCF of 75 per cent is applied to commitments, regardless of the maturity of the underlying facility.

30. The standardised approach appears to be providing a more risk-sensitive approach to commitments than the foundation IRB approach, owing to the recognition of maturity in determining the CCF. This is contrary to the objectives of the Committee of encouraging internationally active banks to move up the continuum of sophistication in the management of risk.

31. The higher CCF of 75 per cent in the foundation IRB approach would further disincentivise banks to evolve from the standardised approach to the more advanced foundation IRB approach.

32. This inconsistency has the potential to create an unlevel playing-field between banks on the standardised and foundation IRB approaches. This issue would certainly make IRB banks less competitive when extending lines of credit to their clients.

33. The BSD requests that the Committee reconsider the calibration of the CCFs, between the standardised and foundation IRB approaches, in a manner that promotes the Committee's objectives, namely:

    a. The Accord should continue to enhance competitive equality.

b. The Accord should constitute a more comprehensive approach to addressing risks.

c. The Accord should contain approaches to capital adequacy that are appropriately sensitive to the degree of risk involved in a bank's position and activities.

Calibration Issues - Equity Exposures

34. Several South African banks raised concerns about the excessively high risk weight for equity exposures in the IRB approach. Under the simple risk-weight method, a risk weight of 300 per cent is to be applied to equity holdings that are publicly traded, and a risk weight of 400 per cent is to be applied to all other equity holdings. On the other hand, under the standardised approach, equity exposures are risk weighted at 100 per cent.

35. The inconsistent treatment of equity exposures under the standardised and the IRB approach will result in level playing-field concerns, which may impact on banks' competitiveness and which may discourage them from moving from the standardised to the more advanced approaches. As argued in the case for commitments, the BSD is of the view that the apparent inconsistency is against the objectives, as described above, set by the Committee.

36. The BSD requests further clarification of the Committee's motivation in prescribing the differing treatment of equity exposures. Furthermore, the BSD recommends that the Committee consider recalibrating the treatment under the different approaches, so as to promote the Committee's objectives.

INTERNAL RATINGS-BASED APPROACH

Specialised Lending

37. Annexure 4 of CP3 provides supervisory slotting criteria for specialised lending exposures. This treatment is applicable only if the banks are unable to meet the requirements for the estimation of probability of default ("PD") under the corporate IRB approach. Banks are required to assess attributes of the transaction (such as financial strength, the political and legal environment within which the transaction is done, specific transaction characteristics, etc) as strong, good, satisfactory or weak.

38. It is unclear how different permutations of the rating of each attribute should be combined to produce an overall rating for a specialised lending transaction as a whole. For example, the financial strengths of the transaction may be rated as good, but the political and legal environment may be rated as weak. The question arising is how to combine the different weightings to derive an overall rating for the specialised lending transaction. The BSD recommends that the Committee incorporate further guidance in this regard in the final document of the New Accord.

39. Furthermore, one bank considers the risk weights in the supervisory slotting criteria for specialised lending to be punitive, especially when compared to the risk weight in the standardised approach, as well as the risk weights for corporate exposures in the IRB approach. The bank in question promotes the argument that owing to the nature of specialised lending transactions, a workout is almost always inevitable, owing to the massive upfront investment by stakeholders, as well as the potential socio-economic consequences that may arise as a result of default (for example, the development of a bridge or road system). The particular bank also believes that such transactions are no more riskier than unsecured corporate lending and should accordingly be treated in the same way.

40. The Committee is requested to provide further guidance on the issue.

Securitisation

41. One bank raised concerns about the "punitive" risk weight of 350 per cent applicable to securitisation exposures rated BB+ to BB- under the standardised approach. The bank in question views securitisation exposures as only marginally riskier than corporate exposures and accordingly sees no justification for a risk weight of 350 per cent as opposed to a risk weight of 150 per cent for corporates rated BB+ to BB-.

42. The punitive risk weight proposed by the Committee for securitisation exposures may have a negative impact on the further development of the securitisation market.

43. The Committee is requested to consider the implications of the disparate treatment of securitisation exposures and corporate exposures. Further investigation may warrant a different treatment in the New Accord.

Lack of Default Data

44. Requirements specific to PD estimation require default data spanning a historical observation period of at least five years. PD estimation, being statistically based, is dependent on a large number of data points to ensure statistical significance. History has shown that there are relatively low levels of default or losses for certain portfolios, such as high quality, large corporates and specialised lending (as discussed above). In both these cases, credit-risk mitigation is put in place, for example through guarantees by parent companies. Furthermore, events indicating potential default will result in restructuring of the exposures, through sophisticated exposure-transfer mechanisms. With regard to bank exposures, default has systemic implications and, therefore, in most cases, supervisory intervention averts a likely default.

45. Low levels of default within certain portfolios result in a lack of historical data, thereby falling foul of the requirements for the estimation of the risk parameters in terms of the proposals for the new Accord. The general lack of data within the market does not even allow for the use of pooled data.

46. A lack of historical data may require alternative methods for the calculation of risk-weighted assets for such high-quality, low-default portfolios. Judgement-based considerations may be appropriate for the rating of such portfolios, given the lack of statistically significant data sets. In such cases, to ensure consistent treatment, supervisors will have to provide appropriate guidelines. The Committee is requested to provide such alternate guidelines for the high-quality portfolios in question.

Credit-risk Mitigation

47. Under the standardised and foundation IRB approach, guarantees or protection is recognised only if the guarantor or protection provider is a sovereign, public sector entity, bank or securities firm. Otherwise guarantees from other entities, such as corporates, will be recognised only if the other entity is rated A- or better.

48. Referring to the foreign-currency versus domestic-currency rating issue discussed above, the BSD requests confirmation that domestic currency rating will be applicable for exposures denominated in domestic currency, and where the transaction is concluded solely within the domestic jurisdiction.

49. Furthermore, several banks considered this requirement punitive. Within the context of emerging markets, the pool of entities rated A- or better is relatively low, implying that only a small proportion of exposures guaranteed will obtain capital relief as a result of credit-risk mitigation. Accordingly, capital requirements under the New Accord will increase owing to the limited recognition of guarantees and protection provision.

50. The BSD suggests that the Committee consider the revision of this requirement such that guarantees will be recognised if the guarantor has an investment-grade rating and is rated better than the counterparty to the lending transaction.

OPERATIONAL RISK

51. The Committee accepts that the advanced measurement approach ("AMA") is at its infancy stage. Banks in emerging-market countries are unlikely to adopt such an approach for implementation in 2006, owing to uncertainties, data constraints and the high costs associated with the development of an AMA framework for operational risk. Thus, South African banks will be adopting either the basic indicator or standardised approaches, the latter being preferred.

52. The QIS results have demonstrated the “double whammy” effect when higher margins resulting from higher risk lending translate into an additional operational-risk charge. The alternative standardised approach certainly goes some way towards resolving the problem. On average, however, this is not sufficient to counteract the increase in the credit-risk charge. Accordingly, operational risk still remains the highest contributor to an overall increase in capital requirements for emerging-market countries.

53. The BSD requests the Committee to conduct further work on applying a similar volume base for the business lines other than commercial and retail. Alternatively, the Committee is requested to consider the recalibration of the β parameter for certain business lines.

CONCLUSION

54. The BSD wishes to reiterate its commitment and the commitment of the banks that it supervises to the New Accord. We believe that the principles proposed encourage sound risk-management practices and will promote a safe and sound banking system. The BSD wishes to congratulate the Committee on its efforts and consultative approach in finalising the new capital-adequacy framework.

55. The comments above merely point to a fine-tuning of the proposals, indicating that the BSD and South African banks are fully supportive of the fundamental principles of the proposed New Accord.

56. The BSD looks forward to working with the Committee in the implementation of the New Accord by the end of 2006.