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Group Executive Director

9th July, 2003

Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Comments on the New Basel Capital Accord Consultative Document 3

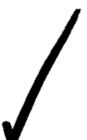
Standard Chartered welcomes the opportunity to comment on the latest draft of the New Accord. We recognise that the Basel Committee has taken account of industry feedback on previous drafts and that many changes for the better have now been incorporated. Whilst there remain some matters of principle with which we disagree, we do also understand that to reach consensus across many jurisdictions and constituencies, compromises will be required. Accordingly, we limit our comments to aspects of the current draft where we believe amendments could greatly improve the ease of implementation without compromising supervisory integrity.

Cross-border implementation

The Overview Paper issued with CP3 makes reference to home/host issues. For international banking groups, this is clearly an issue of major importance. The large number of alternative approaches and national discretions available mean that it is all too easy to foresee a need for international banks to operate parallel systems in order to satisfy the differing needs of lead and local regulators. No doubt this is an unintentional consequence of the way that the New Accord has evolved but it is potentially a cause for major concern. Firstly, it imposes additional operating costs on the banks. Secondly, it carries the corollary that banking groups' total capital will be the sum of whichever is the higher of home and host requirements throughout their geographic spread rather than an objective assessment of their capital needs on a consistent basis. These in turn could lead banks to conclude that marginal businesses in smaller, emerging economies were not worthwhile, discouraging competition and the spread of best practice.

We also note that proposals for banks' accounting rules could potentially be in conflict with the Accord's requirements. It is essential that the Basel Committee and the IASB remain in close contact as their respective proposals develop.

We encourage the Committee to develop clear principles for the resolution of home/host conflicts as a matter of the highest priority. Lack of clarity in this area could be a major impediment to effective roll-out of the Accord.



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Thresholds

In a number of places in CP3 (eg paragraphs 199, 200, 202, 242), thresholds are specified that will result in business being subject to a different classification or treatment according to which side of the threshold it falls. The thresholds are fixed in monetary amounts and there does not appear to be any provision for revising these in line with inflation or exchange rate movements. This could create real difficulties for business that falls close to the threshold, perhaps fluctuating above and below the threshold regularly simply as a result of short-term exchange rate fluctuations. For example, an exposure to an individual of GBP 70,000 is less than EUR 100,000 at an exchange rate of EUR 1.42 = GBP 1 but above it at EUR 1.43 = GBP 1.

Similar considerations apply to portfolios where the overwhelming majority of the constituents fall on one side of a threshold but a small proportion fall the other side. CP3 does not recognise this possibility but appears to assume that all bank portfolios will simply comply with these arbitrary regulatory thresholds. We believe that this is unnecessarily restrictive. It is easy to foresee cases, for example, where banks would normally treat a small borrower under a retail credit process but - not having access to the accounts of other companies in the same group - be unable to prove that it met the group turnover criterion for recognition as SME.

Both problems could be substantially alleviated by allowing a small level of exceptions. We suggest that portfolios could be regarded as qualifying for a particular treatment provided at least 95% of their constituent parts meet the criteria. Similarly, once an exposure has been allocated to a particular class, it should not be reclassified as a result of exchange rate movements unless they take it more than 10% above/below the appropriate threshold. The use test could be employed to ensure that this concession was not being abused.

Maturities

Similar problems occur in those instances where treatments differ according to the maturity of an obligation. Though some "cliff effects" may be inevitable, it is important that their introduction does not conflict with existing market practice. Accordingly, we recommend that maturity cut-offs relating to, for example, a period of "three months" should always be expressed as being inclusive of exposures of exactly that maturity and not end one day short of it. Whilst this is sometimes the case (eg paragraph 38 "original maturity of 3 months or less") it is not always so (eg paragraph 291 "original maturity below three months"). We see no reason for this inconsistency and believe that introducing a regulatory cut-off that conflicts with already well established market conventions should be avoided.

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Conservatism

The Committee have not been willing to recognise banks' own credit risk models in this round but, nevertheless, the calibration of the IRB approaches in the New Accord has been based on the application of a simplified form of credit model. Our understanding is that, like most statistical models of risk, this model uses estimates of mean and variance in order to produce a required level of capital to cover tail risk. We are concerned that some aspects of the minimum requirements will result in banks being forced to bias their inputs away from the true mean and towards a "stressed" estimate. Whilst there may be a place for stress testing within a bank's overall risk management, using stressed inputs to a model calibrated on a non-stressed basis will result in vastly over-stated capital requirements. The inputs should represent a bank's best estimate of normal circumstances.

An example of this is found in paragraph 430. We agree with the use of a default-weighted average for LGD but do not see the relevance of the additional requirement that "the bank must use LGD estimates that are appropriate for an economic downturn". We believe this is both conceptually wrong and practically burdensome. As most defaults occur in periods of economic downturn, a bank's average recovery experience will automatically be weighted towards such periods and to require a yet more extreme "worst case" calculation makes the calculation unreasonably conservative.

The same applies to the requirement for EAD to be appropriate for an economic downturn, contained in paragraph 437.

A similar, practical issue is found in paragraph 409 where "PD estimates must be a long-run average of one-year realised default rates in the grade". A bank will wish its grading scale to display monotonically increasing PDs. It makes no sense for a "better" grade to be associated with a higher PD. In practice, though, it is not at all uncommon to find that there are inconsistencies. For example, the observed default rate for Standard & Poor's A+ rating is higher than that for the A- rating. This does not mean that we should regard A- as a better rating than A+: it is simply a reflection that default data is noisy and needs to be interpreted with an element of judgement and not in accordance with inflexible rules. We recommend that paragraph 409 should be rephrased to require that the performance of the rating system taken as a whole should be in line with actual experience, rather than a requirement relating to individual grades.

Claims on Banks under the Standardised Approach

Finally, we would ask the Committee to reconsider one very specific aspect of the risk weighting in the Standardised Approach. Under Option 2 for the treatment of claims on banks, those banks with external ratings in the range A+ to A- will be allocated a risk weight of 50%. This is considerably more than is economically justified and considerably more than would be implied under the IRB approach, which would give a weight of around 30%. This discrepancy might not be of great significance if the majority of interbank participants use an IRB approach when evaluating their counterparties. We are concerned, however, that the lack of historical default data for this sector may mean that

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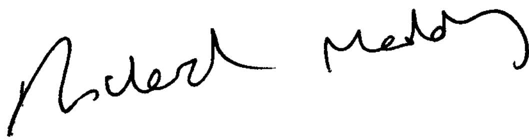
many banks adopt the Standardised Approach for this portfolio. The impact on the relative attractiveness of A-rated banks as against AA or AAA alternatives would then be dramatic and could cause significant changes in market activity. It would be highly undesirable for such a shift to be triggered by a regulatory decision that is not supported by real differences in risk. Accordingly, we suggest that a weight of 30% should be applied to A-rated banks under Option 2 of the Standardised Approach.

Concluding Remarks

We remain supportive of a risk-sensitive approach to capital adequacy and believe that the principles underlying the New Accord are sound and generally in line with market practice. The implementation of these principles will, however, require sensitive and flexible handling in order to avoid conflicts with banks' established risk management processes and to ensure that unintended consequences are minimised. We would be glad to contribute to the continuing debate in this area.

Yours sincerely



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