July 31, 2003

Mr. Jaime Caruana
Chairman, Basel Committee on
Banking Supervision
Bank for International Settlements
CH-4002
Basel, Switzerland

Dear Mr. Caruana:

The World Council of Credit Unions (WOCCU) is the international trade association, development agency and lead advocate for the mutually owned international credit union system representing 40,000 credit unions with more than US$676 billion in assets $590 billion in savings and $67 billion in capital.

Credit unions exist within the retail banking systems of more than 80 countries throughout the developed and developing world. As not-for-profit financial cooperatives, credit unions provide more than 118 million people with access to affordable savings and loans worldwide. As the leading advocate for the international credit union community, the World Council of Credit Unions has been actively involved in commenting, participating in and meeting with the Basel Committee throughout its consultative process on the revised Basel Accord. We commend the Committee for its openness throughout this important process. As a voice for the international credit union community, I submit for your consideration the following comments on the 3rd consultative paper, *The New Basel Capital Accord.*

The Role of the National Regulators

It has always been the intention of the new Accord that national regulators would have wide discretion in how to apply it in their jurisdictions. Whilst supporting this discretion, it is important that national regulators apply the Accord in accordance with the principles of competitive neutrality. In addition, a reasonable and efficient framework must be developed for small, domestic retail financial institutions, such as credit unions, where the Accord will be applied to such institutions.

Principle Areas of Concern – Retail Exposures and Operational Risk

The latest consultative paper, as have most revisions to the draft accord since the initial paper, moves incrementally in the right direction of ensuring equality among the approaches for measuring credit risk (standardized versus internal ratings based approaches). However, we believe the new Accord could go further in its calibration among the approaches. Our review of the results of QIS 3 (in which credit unions participated) indicates that the two largest contributors to changes in capital ratios for the new Accord will be how retail exposures and operational risk are treated.

Retail Exposures – Qualifying Revolving Retail Exposures

With the positive progress to equalize the variation among credit risk approaches, the significant difference between the risk-weights for revolving retail exposures for the standardized and IRB approaches is alarming. The standardized approach applies a blunt risk -weight of 75% for all retail exposures whereas the IRB approach would allow for a theoretical risk-weight of as low as 12.5% for the same exposures. What makes this issue so poignant for small retail-oriented financial institutions is that within QIS 3, changes in the retail exposures accounted for a 4% change in capital under the standardized approach versus an 8-9% change in the foundation and advanced IRB approaches. This equates to a 100% penalty for small retail financial institutions like credit unions in precisely the markets that are fundamental to their survival.

The new allowance for credit risk mitigation techniques within the standardized approach is evidence that the Committee is making the standardized approach more progressive and we would urge such progressive treatment of revolving retail exposures within the standardized approach.

Retail Exposures – Mortgages

For many small financial institutions, it is only their mortgage portfolios that represent a larger share of their balance sheets than revolving retail credit exposures. Unfortunately, this too has been identified as a major impact area in the QIS 3 results. More specifically, retail mortgages under the standardized approach (using the QIS 3 risk-weight of 40%) resulted in a 21% decrease in capital compared to the current Basel Accord. In comparison, the foundation IRB approach resulted in a 56% decrease in retail mortgage related capital holdings compared to the current Accord – this variance of 167% between approaches is unacceptable.

WOCCU is well aware that the 3rd consultative paper has reduced the retail mortgage risk-weight from 40% to 35% under the standardized approach. However, this decrease does not go far enough. Given the IRB's theoretical risk-weight for mortgages of as low as 15%, the difference in risk-weights between the approaches would again be more than 100% – an amount **significant enough to distort pricing** in the fiercely competitive mortgage markets; whereas the risk on the underlying asset may be exactly the same.

Operational Risk

Across all of the participating institutions and all approaches in the QIS 3 it is hard to ignore the sizable likely increase (7-15%) in capital that may occur as a result of inclusion of operational risk in pillar one. The largest increases are occurring among the smaller group 2 banks in the standardized approach. Given these results, WOCCU urges the Committee to review its approach toward including operational risk within the first pillar to create a more flexible framework that can be tailored to a range of organizations.

At a minimum, the Committee should align its thinking between the types of organizations that will use the Basic Indicator Approach, the Advanced Management Approach and business line beta factors in the Standardized Approach. For example, those institutions most likely to use the Basic Indicator Approach (BIA) are small, unsophisticated institutions that are likely to be primarily engaged in retail banking. While retail-banking/brokerage activities have a beta factor of 12% in the Standardized Approach for operational risk, the Basic Indicator Approach has a beta factor of 15% and yet BIA was created for the small retail financial institutions.

Summary of Additional Concerns

The following points are also matters of concern to WOCCU:

- The nature, cost and effectiveness of disclosure requirements remain uncertain and will require exercise of national discretion;

- The potential disadvantage to credit unions posed by the use of external ratings in determining risk-weights (an issue for regional banks as well). This is particularly acute among credit union movements utilizing cooperatively owned centralized liquidity management services referred to as central or corporate credit unions;

- As WOCCU has mentioned in previous comment letters on the Accord and in its meeting with the full Basel Committee in July 2001, the terms "bank" and "corporate" need to be further defined. As related to our previous point, the term "corporate credit union" in the past has caused confusion in the markets as to what risk-weighting should apply since the name "corporate" is part of the name of an institution that performs wholesale correspondent banking activities exclusively for credit unions. Although it should be self-evident for the purpose of the Accord that these wholesale credit unions are considered "banks" not "corporates," there have been cases in the recent past where market participants have considered the wholesale credit unions "corporates" for capital purposes. To eliminate this confusion, we strongly suggest the term "bank" be defined in the Accord to include depository financial institutions. Although on the surface this may appear to be a minor clarification, the large difference between un-rated banks (50% or 20%, for short-term claims,) and un-rated corporates (100%) using the standardized approach is significant and therefore makes this clarification even more important than in the past.

- Credit unions in several markets have raised the concern that the net result of the new Capital Accord and the application of the IRB approaches could, for a relatively small sector of banks, have serious destabilizing effects on domestic retail financial markets. In addition, there are already signs from national regulators that very divergent implementations of Basel II may occur.

As a potential solution, we would prefer to see Basel II apply to only the relevant international wholesale activities on the balance sheets of banking groups, thereby ensuring international consistency without creating an unfair playing field for the domestic retail activities of all financial institutions, including credit unions.

In closing, we strongly recommend to the Committee that the framework of the new Accord should not penalize low-risk retail financial institutions, such as credit unions, that generate a large number of small loans funded by local savings and deposit accounts. **Such a penalty would have the opposite effect of what we believe the intention of the new Accord is: building safe and sound financial systems in the interest of the public at large.**

I would like to thank you for the opportunity to provide these comments and I look forward to future interactions during the implementation stage of the Accord to ensure it is suitable for the international credit union community.

Please contact me at 608-231-7130, or Dave Grace of my staff at 608-231-8494 if you would like further clarification or discussion of these points.

Sincerely,

Arthur Arnold
President & CEO