The World Bank
Washington, D.C. 20433
U.S.A.

CESARE CALARI
Vice President
Financial Sector

July 24, 2003

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

Dear Mr. Caruana:

I am attaching for your review the World Bank's comments on the Basel Committee's third consultative paper on the new capital accord (Basel II). We appreciate Basel's broad consultative process on this critical new accord and we would be pleased to further discuss the points raised in our comments with you and your staff.

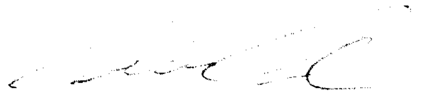
The World Bank welcomes the opportunity for national supervisory authorities to choose among the different options offered by the New Accord as well as to remain with the 1988 Accord. Many countries continue to need to strengthen their accounting standards and loan classification and provisioning rules, without which the new accord will not meet the goal of aligning capital more closely to risk. The recognition by Basel that implementation of Basel II by developing countries will require a longer timeframe than developed countries is a critical message.

Countries that choose to move forward with Basel II will face many challenges in the implementation phase and supervisors are likely to need ongoing guidance and advice on best practices. Areas where more detailed guidance may be necessary include the evaluation of sovereign risk and the criteria by which to assign risk weights to retail portfolios, SME and real estate lending. There is a need to heighten awareness of the risks of lending in foreign currencies. For many client countries of the World Bank, concentration risk will continue to be a major issue and options as to how to address this through Pillar II are needed. Further refinements are needed to the calculation of operational risk and, in addition, countries moving toward internal ratings will need guidance regarding calibration.

We want to take this opportunity to offer specific comments on the document as well as on the future direction of work, some of which is already going forward in some

working groups. From this perspective we particularly welcome the current work being done by the Accord Implementation Group regarding cross border implementation issues. We look forward to continuing to work with them on Basel II implementation issues and challenges as well as with the Capital Group and Core Principles Liaison Group.

Sincerely,



Cesare Calari

Attachment

THE WORLD BANK

World Bank Staff comments on the Basel Committee's Consultative Paper 3 (CP3)

General Considerations

The World Bank wishes to express its appreciation for the extensive consultation policy followed by the Basel Committee on Banking Supervision (BCBS) that has made possible a continuous refinement in the calculation of bank capital requirements. As a result of this process, a number of new features have been introduced in the Capital Accord, including: the introduction of a simplified option within the Standardized approach, the new consideration given to loan loss provisions in the definition of banks' capital requirements, a better definition of the principles to guide bank supervisors in their review of capital adequacy and a more detailed list of the relevant set of information for public disclosure.

As the Accord moves toward finalization the introduction of a multiplicity of regulatory options in the domain of minimum bank capital requirements will inevitably place a higher burden on bank supervisors. In order to ensure the comparability and transparency of capital regulation across countries, the World Bank considers that additional clarification is needed to assist supervisors as they move forward with implementation issues. For this reason it is desirable that additional emphasis be put on the relationships between capital requirements and accounting standards, consolidation criteria, loan classification and provisioning rules. We welcome the opportunity to continue the dialogue on these issues with the Accord Implementation Group.

The World Bank supports the efforts of the Basel Committee to establish a stronger relationship between the empirical assessment of credit risk embedded in banks balance sheet and capital requirements and feels that the calibration of current capital requirements has improved as a result of the quantitative exercises conducted by banks from both G10 and non-G10 countries. The World Bank still views the current risk weights as largely defined on the basis of evidence from G10 countries which may offer very different levels of protection in emerging economies. Going forward, the issues on which the Bank would like to work together with Basel, especially with regard to sharing cross country experiences, to provide more guidance to developing countries, are as follows:

Pillar 1

Risk weights of individual claims.

- Sovereign risk. The principle that lower risk weights can be applied to domestic (versus foreign) currency denominated sovereign debt should be supplemented by criteria that national authorities could follow when making their risk weight determinations to avoid a competition in laxity among national supervisors.

- Retail portfolios, SME lending, and real estate lending. The definition of retail and SME lending reflects standards prevailing in large industrial countries and does not appropriately capture the risk features of similar size firms in smaller economies. The discretion left to national authorities to set higher capital requirements for retail portfolios, SME and real estate lending could, as in the case of sovereign borrowers, be complemented by a list of criteria that could ensure some coordination among bank supervisors in different countries.
- Lending in foreign currency. Many episodes of bank crises in the last decade have been exacerbated by banks' underassessment of the greater credit risk associated with lending in foreign currency. The growth of foreign currency denominated debt in the corporate sector, unmatched by a parallel growth of foreign currency assets or foreign currency revenues, has been increasingly a source of corporate and banking distress. These developments suggest extending to the corporate sector the criteria adopted for sovereign risk exposure where a higher risk weight is associated with foreign currency exposures.
- Calibration of IRB capital requirements. The quantification of capital requirements in the IRB approaches should be supplemented by examples of calibration methodologies and by procedures for testing the effectiveness of calibrations in different economic and financial environments. Lack of guidance in this area will make it particularly difficult for bank supervisors to exert their discretion, especially when validating the approaches of banks that choose to follow the internal model approach.

Concentration risk.

- The higher level of risk associated with banks' loan concentration is a particularly relevant issue for emerging economies. At present, concentration risk is considered only under Pillar 2. This solution is likely to be unsatisfactory as long as it leaves unspecified the relationship between increasing levels of loan concentration and additional capital requirements. It would be desirable to specify the maximum level of bank loan concentration for which the proposed capital regulations are expected to provide adequate protection as well as cross country experience in this area.

Operational risk.

- Evidence from the QIS 3 shows that the largest increase of capital requirements among non-G 10 countries is tied to the new operational risk requirements. The lack of robust empirical evidence of the relationship between credit risk and operational risk in emerging countries requires a continuation of the efforts to define an appropriate quantification of operational risk,in less developed institutional frameworks.

Pillar 2

Preconditions. The Accord should re-emphasize that successful implementation of Basel II will require having a minimum set of preconditions in place, as outlined in the Basel Core Principles.

Loan classification and provisioning. The Capital Accord has provided an initial but only partial integration of the discipline of provisioning and capital requirements, which should be carried forward in view of the far-reaching implications that inadequate provisioning has on banks' capital. For developing and emerging economies, the lack of integrated rules for assessing bank loan risk exposure for both provisions and capital requirements restricts the relevance of the capital adequacy framework, reducing the comparability of systems across countries. In fact, ill-designed frameworks have contributed to hiding banks' insolvencies, as demonstrated during the Asian crisis and elsewhere.

Pillar 3

Public disclosure represents a fundamental component in the mutual reinforcing system of checks and balances that is required to ensure effective bank capital regulation. Public disclosure of information exerts its disciplining effects not only for countries with developed financial markets but also for emerging economies. In addition, under a multi-option capital regulation framework a larger volume of disclosure is necessary to compare risk exposures and capital requirements across countries, insuring a level playing field. In addition to the disclosures in Pillar III, national supervisors may want to consider additional disclosures as they are relevant in their jurisdictions.

- Bank credit composition by currency of denomination. It is highly desirable that the information on the currency composition be added to the other quantitative disclosures of credit risk composition (by sector, geographic area).
- Senior managers' compensation structure. Disclosure of the criteria underlying the compensation structure for senior bank managers would help to prevent excessive compensation for growth at the expense of prudent risk management.
- Public disclosure on the part of bank supervisors. The Basel Committee could provide guidance as to what information supervisors should publicly disclose, e.g., supervisory procedures for evaluating banks' capital assessment and rules and procedures applied for customizing capital ratios.