"Comments of developing countries on the April 2003 Consultative Document of the Basel Committee on Banking Supervision (BCBS), The New Basel Capital Accord"

Remarks of Andrew Cornford, Financial Market Center, to WADMO Conference/General Assembly, 12 November 2003

The following review is based on comments on the third consultative document on the New Basel Capital Accord of April 2003 (CP3) made by central banks and supervisory authorities of developing countries an by national or regional industry associations of such countries (henceforth "respondents") and available on the web site of the BCBS.

Scope of application and cross-border implementation

Issues raised under this heading involve the following:

- *The banks to which the New Basel Capital Accord (NBCA) would apply*. Here views expressed indicate that in different countries application would range from being universal to being limited to "internationally active" banks. Several respondents favour a definition of "internationally active banks" by the BCBS;
- *The structure of banking groups, consolidation, and the levels at which national supervisors should conduct their reviews*. The problem here is that many banking groups have complex structures which may involve different categories of entity – such as branches, subsidiaries and joint ventures – in different locations. The respective responsibilities of the supervisors in a banking group's home country (parent supervisor) and of the supervisors in the host countries of its foreign entities (the host supervisors) have been addressed by the BCBS at various times. However, there is clearly a widespread wish to have the particular application of these principles to the NBCA spelled out more explicitly;
- *Closely related to question of the respective responsibilities of supervisors in different countries under the NBCA is concern as to the possible consequences of situations in which supervisors in different countries prefer banking entities in their jurisdictions to adopt different capital standards*. Several developing-country supervisors expect most or all local domestic banks to adopt the simple standardised approach, and many would prefer, and may even impose, this approach owing to limitations on their capacity to carry the more complex supervision required by the internal ratings-based approach (IRBA) and, indeed, may be under pressure from their parent supervisor to do so.
- *The resulting dilemma has a number of aspects*. The host supervisor might reach an agreement with the parent supervisor under which it abdicated many of its responsibilities with respect to the supervision of capital adequacy to the home supervisor, permitting the foreign entity to use the internal ratings-based approach (IRBA). But a consequence of this decision would be a banking regime with two tracks, one for domestic banks and one for foreign banks. Since the IRBA is expected to lead to lower levels of capital and thus lower costs for banks adopting it, domestic banks could be put at a competitive disadvantage by such a regime. On the other hand, if the host supervisor imposed the standardised approach on entities in its jurisdiction regardless of the approach adopted by the parent bank (which might be the IRBA), the costs and complexities of supervising the banking group could rise substantially.

Timetable for implementation of the NBCA

According to the current timetable, implementation of the NBCA is to be achieved by the end of 2006, but several respondents expressed the view that this deadline is unrealistic and that a longer transition period will be required.

Credit rating agencies and the calibration of credit risk under the standardised approach

Widespread reservations are expressed concerning the dependence of the ratings of credit risk on credit rating agencies under the standardised approach. A major problem here is the absence of credit raging agencies in many developing countries. Moreover typically only a small minority of firms in most developing countries currently have ratings from the major agencies. As a result non-financial firms and insurance companies will receive the undifferentiated rating of 100 per cent assigned to unrated firms. Other misgivings concerning major credit rating agencies are a widely perceived lack of understanding on their part of local conditions in several developing countries and their unregulated status. Some respondents also draw attention to the agencies' failure to adjust their ratings before as opposed to during recent financial crises involving both countries and firms.

Procyclicality of ratings

The failure of the rating agencies as forecasters contains the risk that downwards shifts in their ratings are capable of magnifying economic downturns and financial crises – of having what is usually described as a procyclical effect. Use of the agencies' ratings for the calibration of credit risk under the standardised approach could easily lead to lower levels of lending and higher borrowing costs for entities adversely affected by shifts in these ratings and thus aggravate the very conditions which led to the shift in the first place. *Procyclical effects under the NBCA are not limited to the standardised approach but could also result form unfavourable shifts in banks' internal ratings under IRBA*. A number of respondents' concerns are directed not only at the procyclicality of the IRBA in general but also more specifically at that which might result form tests carried out to meet part of the supervisory requirements for eligibility for the IRBA. Here it is felt that such tests may lead to a bias towards stressed conditions, and thus towards excessive conservatism, in setting capital levels. Particular concern is directed at para. 430 of the NBCA where it is stated that "the bank must use LGD (loss given default) estimates that are appropriate for an economic downturn if those are more conservative than the long-run average" and para. 437 where it is stated that "the bank must used EAD (exposure at default) estimates that are appropriate for an economic downturn, if these are more conservative than the long-run average".

Risk weights of the standardised approach: interbank and small loans

Interbank lending and some other categories of exposure were singled out for concern regarding their assigned risk weights under the standardised approach.

- Regarding claims on other banks one respondent points out that the risk weight assigned to banks with a certain credit rating under the standardised approach would be substantially higher than, and thus inconsistent with, that assigned under the IRBA. Other respondents want a relaxation of the rules for the maturity of claims on banks – an original maturity of three months or less – that would qualify them for preferentially low risk weights. And one respondent would prefer delinking of the preferential risk weight for claims on banks from their maturity and leaving the assignment of their risk weights to national supervisors on the basis of their underlying strength and creditworthiness.

- One respondent wants a further gradation of the risk weights for small loans with an intermediate weight of 50 per cent assigned to consumer loans between those of 35 per cent for residential mortgages and 75 per cent for other retail loans.
- The suggestion is also made that the risk weight of 100 per cent should apply to firms with a wider range of ratings than the NBCA's BBB+ to BB-.

Options as to use of the IRBA

Under the 2001 consultative paper on the NBCA (CP2), banks were given little latitude in their adoption of the alternative versions –foundation and advanced– of IRBA. Once a bank met the requirements for an of the elements of the advanced version of the IRBA, it could proceed to adoption only on condition that steps were taken to enable it also to adopt other elements of the advanced version in a reasonably short time. *CP3 is more flexible and permits "a phased rollout of the IRB approach", adopting IRBA, for example across asset classes within the same business unit or across business units within the same banking group, or moving from the foundation to the advanced version of the IRBA only for some inputs to the estimation of risk-weighted assets*. The "phased rollout" of CP3 is, however, to be part of a progressive plan in the direction of full implementation. Similar flexibility, it should also be noted, is accorded in CP3 under the Advanced Measurement Approach (AMA) to setting capital requirements for operational risk, adoption of this approach being permitted for some parts of a bank's operations and simpler approaches for the rest. *Several respondents would like further flexibility under which partial adoption of the IRBA would be permitted for more narrowly defined activities*, and one respondent supports national supervisory discretion for approval of permanent but partial adoption of the foundation version of the IRBA (which would exclude exposures to sovereigns and banks for which, owing to limitations on the availability of data for PD, capital requirements may be better treated under the standardised approach).

IRBA: formulas for risk weights and the treatment of SMEs

Several respondents express the view that the design of the formulas used to estimate capital requirements under the IRBA reflects conditions prevailing in G-10 countries and thus takes insufficient account of conditions in developing countries. One point referred to here is the preferentially low risk weight for SMEs, which was a response to representations from within the G-10 that the formulas of CP2 were capable of imposing punitive interest charges on SMEs and thus compromising their role as the major source of employment in many economies. Some respondents believe that the case for a lower risk weight for SMEs is unproven, exposures in this class being at least as risky as those to larger firms. A more widely expressed concern in that the ceiling on annual sales of 50 million euros defining eligibility for inclusion in the category of SMEs is too high for several developing countries and would result in the inclusion of few firms in the exposure class of non-SME corporate entities.

Portfolio diversification and interest rates on developing countries' international borrowing

It is a longstanding criticism of the capital requirements prescribed by the original 1988 Basel Capital Accord and the proposals so far for the NBCA that they do not take sufficient account of the potential benefits of risk reduction due to diversification of loan portfolios across major exposure classes. *The focus of respondents reviewed here is on the benefits of a portfolio containing exposures to both developed and developing countries as opposed to one containing exposures only to the first group owing to the lower risk of the former which results from lower correlations of major financial and macroeconomic indicators for the combined group than for the first group on its own.* Failure to account for these benefits will, it is believed, lead to large increases in regulatory capital for lending to all but a small minority of developing countries and correspondingly large increases in their cross-border borrowing costs. Two approaches are proposed to dealing with the problem. One, which follows the submission to the BCBS of Griffith-Jones, Spratt and Segoviano, would reduce capital for banks which held appropriately diversified portfolios of exposures to both and developing countries. The other, which has more the limited objective of protecting intra-developing country lending from excessive charges linked to the rules of the NBCA, would provide discretion to national supervisors as to the setting of risk weights for exposures to borrowers from within the same region.

(In view of the prominence of this argument in the comments of respondents, I should like to interject a few remarks of my own on the subject. The basic argument seems incontrovertible as to the benefits in terms of reduced credit risk of a loan portfolio appropriately diversified across borrowers from developed and developing countries. But translating this into operational rules seems likely to be more difficult than Griffith-Jones, Spratt and Segoviano admit. The level of diversification to be undertaken by the bank to quality for a reduction in capital requirements in their proposal would presumably have to be linked to a correlation factor reflecting the risk of its combined exposures to both developed- and developing country borrowers. Since credit for diversification of the portfolio "could function in a tapered fashion", a correlation factor which varied with the proportions therein of developed- and developing-country exposures would presumably be required for this purpose. While such a variable factor could presumably be determined on the basis of data similar to those used to derive other parameters in the formulas for estimating capital requirements under the IRBA, the exercise may prove less straightforward than the authors seem to believe and probably would add to the complexity of the NBCA. But this is not an argument for not including such an option if the calibration of credit risk could be reliably improved thereby, and if the techniques of credit risk mitigation in the NBCA would not be effective in bringing levels of financing costs to developing countries down to acceptable levels. I am not sure that the adjustment factor in the IRBA to take account of the lower risk of exposures to SMEs, which is also mentioned by Griffith-Jones, Spratt and Segoviano in this context, provides a good analogue for handling the benefits of diversification since the reduction in capital requirements for SMEs under the IRBA is due to a lower correlation factor for exposures within the group, and not for one reflecting the effects of diversification across this and other groups.)

Data requirements for the use of IRBA

There are several references to the difficulties of meeting the data requirements for eligibility for the IRBA, and this is an area where there is also a widely perceived need for technical assistance. Two other points are also mentioned by respondents. One concerns the acceptability of using portfolio data for PD where data on individual losses are lacking. And another concerns the need for guidelines in the NBCA for the comparability of the data base for the IRBA in the case of banking groups operating in several countries.

Credit risk mitigation and collateral

The eligibility and valuation of collateral has proved one of the most contentious issues of the NBCA. This should not be surprising in view of the wide variety of existing practices in this area, which reflect different customs and different degrees of development of the markets where financial instruments, real property and other goods serving as collateral can be bought and sold or valued. *The rules in CP3 have been extended in various ways to accommodate representations reflecting this variety. But the new round of comments suggests a widespread belief that BCBS's response has not yet gone far enough*. Real property remains especially important for the collateralisation of loans in Asia, so that unsurprinsingly suggestions for greater flexibility in this area are particularly numerous from this region. Particular topics include more flexible rules for the mortgages secured by commercial property under the standardised approach and a relaxation of the eligibility criteria and lower floors for LGD for commercial and residential real estate under the IRBA. Proposals from other respondents include more flexible conditions for the valuation of real collateral (difficulties regarding which for several developing countries reflect the lower level of development of markets for this purpose). In the case of guarantees and credit derivatives, proposals include a broadening of the rules as to eligibility for protection providers and , under the latter heading, recognition of other transactions in addition to credit default swaps and total return swaps for the purpose of credit mitigation.

Expected and unexpected losses (EL and UL) and loss provisions

The approach of the BCBS to EL and UL in setting capital requirements has differed from that of the literature on the management of banking risks which treats the former as a cost of doing business to be covered by reserves or provisions, leaving the latter to be covered by capital. Owing partly to the difficulty of achieving international agreement of a definition of loss provisions and reserves, the intention of the BCBS is that capital should cover EL as well as UL, and general loss provisions are included in capital up to a ceiling. The NBCA has taken some cautious steps to permit greater recognition of loss provisions not already included in capital to reduce risk-weighted assets classified as EL. A number of respondents would like the BCBS to go further in this direction or in the recognition of provisions as part of capital.

Operational risk

Here respondents focus their comments principally on the levels and inconsistency of the proportions of key indicators of a bank's activities used to set capital levels under the two simpler approaches, the Basic Indicator Approach (BIA) and the Standardised Approach, and the restriction of the recognition of insurance for operational risk mitigation to the third more sophisticated approach, the Advanced Measurement Approach. However, there is also still some scepticism concerning the case for quantified capital requirements for operational risk under Pillar 1 as opposed to handling the subject under supervisory review (Pillar 2). Many respondents view the proportion (alpha) of 15 per cent applied to the bank's average gross income under the BIA as leading to excessive capital for operational risks since in developing countries interest margins are often higher than in developed ones, since they are attributed a more important role in offsetting credit risk. It is even pointed out here that if income resulting from these margins is used to increaser reserves, the same risks may be covered by capital under two different headings. Moreover, the proportions (betas) applied to the income of business lines under the Standardised Approach are widely viewed as too high to provide the desired incentive for its adoption in preference to the BIA. Several respondents expressed support for recognition of the risk mitigating effect on operational risk of insurance in the form of a reduction of the capital charge.

Pillar 2/supervisory review

Support for national supervisory discretion by some respondents is balanced by the concerns of others that insufficient or inadequate supervisory guidelines under Pillar 2 may compromise attainment of the objective of a level playing field for banks internationally. Several respondents emphasize the shortage of supervisory resources in their countries for implementing NBCA, particularly its more advanced and sophisticated options, a shortage likely to be aggravated by competition for the limited supply of people with supervisory training form the private sector.

NBCA and IMF surveillance

There is some opposition to any rapid inclusion of implementation of the NBCA in the IMF-World Bank Financial Sector Assessment Programme (FSAP) and in IMF surveillance of countries' financial sectors. This opposition is due to the complexity of such implementation and to the closely related matter of the shortage of supervisory resources just mentioned. The need is thus emphasised by some respondents to limit surveillance of capital adequacy and associate risk management by banks to the relevant parts of the BCBS's **Core Principles for Effective Banking Supervision** at a general level.

Pillar 3/transparency and market discipline

There is scepticism on the part of some respondents as to the value of disclosure on the detailed scale prescribed under Pillar 3. Amongst te points made here is that the disclosures of CP3 are designed to enable investors to exercise market discipline. However, in many developing countries depositors are likely to have a more important role under this heading, and some respondents want greater national supervisory discretion for this area. Several respondents also emphasised the need for increased cooperation between the BCBS and the IASB regarding banks' disclosures.

Representativeness of the drafting and implementation of the NBCA

Despite the scale of the consultation exercise undertaken in connection with the NBCA reservations have still been expressed as to the representatives of the process involved. Specifically there is a reference to the inadequacy of the attention paid to the problems of small open developing economies. One respondent has suggested that coherent implementation of the NBCA in the large and diverse number of jurisdictions concerned would be facilitated by an enlargement of the membership of the Basel Accord Implementation Group to make it more representative of non-G-10 countries.

Miscellaneous

- Several other specific points are covered in the comments of respondents, including the following:

- Inconsistencies between related parts of the text of CP3 and lack of clarity concerning some subjects;
- The increased capital requirements indicated by the third Quantitative Impact Study (QIS) for banks using the standardised approach;
- Cross-holdings of bank capital, a subject on which one respondent feels that the rules of the NBCA prescribing deduction of such holdings from capital are too restrictive;
- Incentives to regulatory arbitrage between banks' banking and trading books;
- The rules as to when domestic –or foreign– currency ratings should apply when unrated borrowers are assigned a rating under the standardised approach which is based on the rating of an equivalent exposure.

Supervisory rules versus supervisory principles

One respondent would like to see a shift in emphasis in the NBCA from "rigid, prescriptive risk management methodologies towards a more principles-based approach". Owing to what I consider the importance of this point I shall depart from my practice so far and name the respondent, Hong Kong (China). I cannot help wondering if the BCBS's task would not have been easier if it had chosen the path of a shorter, more principles-based NBCA, which would be annexed or supplemented by more detailed and technical supervisory guidelines such as are now included in the NBCA itself. An objection to this approach is that it would not achieve the objective of a level playing field for banks internationally. This is a matter on which honest judgements may differ. While detailed rules are capable of promoting competitive equality, they also usually furnish new opportunities for regulatory arbitrage and may be associated –as recent corporate scandals amply illustrate– with compliance with the letter rather than the spirit of regulation.