Comments of the Reserve Bank of India on
A New Capital Adequacy Framework*

1.Introduction

The first Capital Accord of 1988 played a positive role in strengthening the soundness and stability of banks and enhanced the competitive equality among international banks. The Accord provided a framework for a fair and reasonable degree of consistency in the application of capital standards in different countries, on a shared definition of capital. Due to rapid transformation of the financial market since 1988 Accord, situation has arisen where regulatory capital alone may not be a good indicator of financial condition of banks. It is therefore, essential that the capital, which supervisors mandate the institutions to hold, should be adequate to cover the risks to which the institutions are exposed.

2.Reserve Bank of India (RBI) appreciates the Basel Committee's initiative in addressing the rigidities of the 1988 Accord and to propose the new Framework with a view to rectifying the shortcomings the 1988 Accord had on the balance sheet strategy and also in addressing the in-built deficiencies in the risk- weighting model. RBI acknowledges that the three-pillar approach proposed in the new Framework will suitably enhance, in due course of time, the role of supervisors, on the one hand and the 'market' on the other, in ensuring that the regulated entities maintain adequate capital at all times with reference to their risk profile. This approach would also serve to contribute to the international financial architecture.

3.RBI also appreciates the Basel Committee's proposals designed to improve the way the regulatory capital reflects the underlying risks, to better address the risks arising from financial innovations in the recent years and to recognise risk mitigation through improvements in risk management and control.

4.RBI shares the Basel Committee's acknowledgement that the methods used to determine the capital charges for credit risk in the current Accord are not overly sophisticated and financial innovation and growing complexity of financial transactions have reduced its efficacy. The Committee's proposal to assign greater role for supervisors in encouraging banks in developing internal models for setting capital, commensurate with risk profile, greater disclosures and adopting sound accounting and valuation practices as the basis for setting capital requirements is also laudable.

RBI, thus, endorses the Committee's proposal to replace the current broadbrush approach with preferential risk weighting. RBI is also in agreement with the Committee's proposal to develop an explicit capital charge for other risks viz., operational risk and interest rate risk in the banking book for banks where interest rate risks are significantly above average (outliers).

5.Issues Specific to Emerging Markets

While appreciating the Committee's efforts to address the rigidities inherent in the 1988 Accord, RBI is generally in agreement with the approach of the new Framework. However, it is suggested that the issues and problems specific to emerging markets may also be taken into account in the new Framework. The dependence of these markets on agricultural sector and its seasonality, low competitiveness, vulnerability of the external sector, low technical skills of the market players, etc., ought to be recognised and properly addressed. Some of the proposals contained in the new Framework may therefore, require some modification / flexibility to fully reflect the macro-economic environment, structural rigidities and concerns of the emerging markets.

6.RBI has examined all the aspects of the proposed framework and the comments are detailed hereunder: -

6.1 Scope of Application

6.1.1 While appreciating the Committee's proposal to extend the new Framework to include, on a fully consolidated basis, holding companies that are parents of banking Group to prevent double gearing of capital, *RBI feels that the application of the Framework on stand-alone basis with full deduction from total capital should continue to be an alternative, where banks are of simple structure.* The subsidiaries, established by banks should, however, be subjected to capital adequacy and other prudential norms and supervision on stand-alone basis. Thus, the existing practice of applying total deduction method for calculation of the bank's capital together with the need for recognition and making full provisions for any long-term diminution in the value of investments in the equity of subsidiaries that would obviate the risk of double gearing, should be recognised as an alternative to the proposed approach of full consolidation.

6.1.2 In this context, RBI agrees with the views of the European Commission that although consolidation is the preferred method, there are special cases where alternative supervisory tools, e.g., deduction may be appropriate. However, as the alternative techniques do not yield the same results, the choice of an alternative method should be subject to supervisory discretion.[1] Further, the deduction of minority owned stakes across-the-board, in all cases, would impair the autonomy of banks in efficient asset allocation as banks are holding shares of entities like corporates, other banks and financial institutions in their **trading books** with the intention of realising short-term capital gains.

RBI is of the view that minority stakes taken up by banks in the equity of other banks /financial institutions, as one of the promoters, which are held for strategic reasons on long-term basis and held in the banking book alone be deducted from the investing bank's / FI's total capital, in addition to the total deduction of majority-owned stakes in subsidiaries.

6.2 Cross- holdings

6.2.1 Considering the rapid growth of financial system globally and the multiplicity of players in the financial markets, some cross - holding of banks' capital is inevitable. The Basel Committee has already provided discretion to national supervisory authorities in the 1988 Accord to prescribe a **material limit** upto which such cross-holdings could be permitted.

RBI is of the view that where the supervisory authorities have prescribed a limit on cross-holding of banks' capital, which is considered safe in ensuring the stability of the financial *system, the discretion should continue. Any excess investments above the material limit could be deducted from the investing bank's/financial institution's total capital.*

6.2.2 *RBI agrees that there is a need to continue efforts at aligning capital standards of banking, securities and insurance supervisors in order to assist the assessment of conglomerate-wide capital adequacy.* **.** *At the same time, it should be recognised that prescribing uniform standards might not always be feasible for heterogeneous financial conglomerates (including insurance companies) where the risk profile of various activities is of different magnitude.*

6.3 Role of External Rating Agencies in Risk Weighting

6.3.1. RBI shares the Committee's concerns about the incentives and consequential effects of a more extensive use of external assessments in the Framework and the view that the national supervisors should not allow banks to place assets in preferential risk weighting categories based on external assessments in a mechanical fashion. Rather, the banks should do so only where they themselves and their supervisors are satisfied with the quality of assessment source and methodology.

6.3.2 *RBI considered in depth the issue of relying on external credit rating agencies which are mainly located in the United States, as the basis for assigning preferential risk weights and it is of the firm view that assigning greater role to the external rating agencies in the regulatory process would not be desirable, for different rating agencies resort to different parameters for risk evaluation, which are often not transparent.* Major external rating agencies also often differ in their attribution of ratings. For instance, a survey of the sovereign ratings of Moody's and Standard and Poor as of June 1995 showed that they agreed for ratings of AA/Aa or above in 67% of cases, for other ratings of investment grade in 56% of cases, and for ratings of below investment grade in 29% of cases.[2] The low level of agreement below the investment grade is significant for emerging markets, as most of them are currently rated in this category. In such an environment, the adoption of the proposed framework would have significant impact on emerging markets. Apart from the lack of uniformity in selection of parameters, the mix and weightage of objective and subjective factors also vary, which may lead to incorrect assessments. The experience of South East Asian crisis stands testimony to this. Due to enormous subjective element involved in the rating process and the lack of transparency in risk assessment, and other reasons, the role proposed to be assigned to the external rating agencies is a matter of supervisory concern and needs reconsideration. This is particularly so in emerging market economies which are assigned sovereign credit ratings which put an upper limit on corporate credit ratings, irrespective of their individual credit worthiness and past debt service record.

RBI is therefore, of the view that the external rating agencies should not be assigned the direct responsibility for risk assessment of banking book assets.

6.3.3 Instead, RBI prefers that the assessments made by the domestic rating agencies that have up to date and ongoing access to information on domestic macro-economic conditions, legal and regulatory framework, etc., could be a better alternative source for assigning preferential risk weights for banking book assets (excluding claims on sovereign), subject to adequate safeguards.

This would facilitate the national supervisory authorities to have greater access to the quality of assessment sources and methodologies used by various rating agencies. This would also facilitate evolving country-specific parameters for rating of various counterparties. Where, however, banks are allowed to use assessments made by domestic rating agencies as the basis for preferential risk weighting, there should be at least two assessments of the same category to avoid rating shopping.

RBI is therefore, of the view that domestic rating agencies should be assigned a greater role in the risk assessment of banking book assets, subject to adequate safeguards.

6.3.4 RBI also favours that greater reliance needs to be placed on internal ratings-based approaches of banks, which could be structured under an acceptable framework so that a standardised approach to internal rating could be adopted. As stated by the European Commission, the internal ratings-based approach could incorporate supplementary customer information, which is typically not available to credit assessment institutions. It could also extend to a greater number of counterparties such as unrated borrowers in the small / retail sector. This will encourage banks to refine their risk assessment and monitoring process, which would facilitate better management of their loan books. The regulators should, however, evolve suitable process and criteria for approving the rating framework so as to ensure the integrity of different banks' systems and that the parameters are consistent and comparable across various banks. While encouraging banks to use their own internal rating systems for better distinguishing credit quality, the issues relating thereto viz. mapping of banks' grades into a series of regulatory risk weight baskets, development of capital charge on the basis of rating grades, ensuring consistency between the **standardised approach** and an **internal ratings-based approach**, minimum standards and sound practice guidelines for key elements of rating process and supervisory process for validating internal ratings-based approach should be adequately addressed and a common standards review mechanism should be put in place. The banks should also be mandated to disclose the methodologies and processes so that regulators and other parties understand about the differences in methodologies and performance of internal rating systems.

RBI is of the view that as an alternative to the rating system by external rating agencies, supervisor-validated internal rating systems, developed by credit institutions themselves could be accepted as a standard tool for risk assessment of banking book assets.

6.4 Claims on Sovereigns

6.4.1 *RBI welcomes the Basel Committee's approach to dispense with the grouping of the countries into OECD/Non-OECD for assigning risk weights.*

6.4.2 As regards the concerns expressed by the Basel Committee regarding track record of rating agencies, it is beyond doubt that the credibility of external rating agencies has eroded as they failed to anticipate both the on-set and the scale of the South East Asian crisis. They have generally failed to give either a warning of crisis or accurately reflect economic fundamentals. Instead, when the crisis broke out, sudden and rapid downgrading of the affected countries was resorted to, which led to rapid outflow of capital, thus worsening the financial crisis. For instance, at the heights of financial crisis, Thailand was downgraded 4 notches by Moody's and S&P between July 1997 and early January 1998; Korea was downgraded 6 notches by Moody's and 10 notches by S&P during the same time.[3] If the external credit rating agencies' perception is also mirrored in market sentiments, such rapid changes in ratings, would be capable of exacerbating volatility in all segments of the financial markets and in the process hasten the magnitude of financial crises. Rating agencies have come under severe criticism from a number of quarters either for having been too lenient in their initial ratings, or for having been too pessimistic in their revisions or both. In fact, after the Asian financial crisis, the rating agencies have themselves acknowledged, either explicitly or implicitly, inadequacies in their rating methodologies prior to the crisis.

6.4.3 Assuming that the rating is correct at any given point of time, a downgrade or the threat of a downgrade could exacerbate the tendency of financial institutions to **'risk for exit'** when a country's economic performance deteriorates. This tendency was visible in the recent past and an across-the-board increase in capital requirements because of **sudden rating downgrades** could make the problem worse. The linking of capital charge to credit ratings would also lead to the possibility of introducing a cyclical bias due to rating downgrades during financial / economic downturns**.** In fact, the rating agencies had introduced a pro-cyclical element to capital flows and had contributed to excessive capital inflows to emerging markets as well as their abrupt reversals. Further, their assessments are sometimes inaccurate and their objectivity and independence are not always guaranteed**.** Much of their ratings are influenced by present situation without due consideration to future perspectives. There is also no system to make the rating agencies accountable for sharp deterioration in the credit quality of rated entities immediately after assigning a rating.

6.4.4. Also, the emerging markets are structurally different from the developed economies**.** Most of the emerging economies still depend on agriculture as a main source of GDP, employment and export earnings. The agricultural sector is susceptible to vagaries of nature. The seasonality of agricultural sector and its impact on macro economic situations should ideally be, but are not taken into account by external credit assessment institutions, which apply the same parameters to both developed and developing economies. Another fact to be recognised here is the presence of subjective elements in the ratings of the external agencies. This kind of multiplicity of subjective elements no doubt erodes the credibility of ratings.

RBI is of the view that external assessment agencies should not be assigned the direct responsibility for risk assessment of banking book assets. The alternative of relying upon the assessments of export insurance agencies in the G-10 countries may not also be a feasible option as their independence and judgements are also not clearly established. Further, the focus of export insurance agencies is generally on different aspects of country risk and basically confined to ratings of sovereigns. It would also be difficult to map the ratings of such agencies with regulatory risk baskets. RBI is therefore, not in agreement with the proposal to assign risk weight to claims on sovereigns in the range of 0% to 150% (100% for unrated), based on external assessments. Instead, RBI feels that the new Framework should propose '0%' risk weight for claims on all sovereigns. RBI is also not in agreement with the proposal to link the eligibility of a sovereign, for a risk weight below 100%, to its subscribing to the IMF's Special Data Dissemination Standards (SDDS).

RBI, however, fully endorses the proposal to provide discretion to national supervisors to give modified treatment for banks' exposure to their own sovereign (including Central Bank) denominated in domestic currency and funded in the same currency. This is particularly relevant for emerging market economies.

6.5 Claims on Banks

6.5.1 Under the first option (viz., of applying the risk weight, which is one category less favourable than that of the sovereign), the bank's credit risk would not be reflected by the risk weight i.e., the claim on a very high quality bank would receive the same risk weight as the claim on a very low-quality bank. This option would therefore, penalise banks with better quality asset portfolio incorporated in low rated countries while benefiting weaker financial institutions in highly rated countries. The risk weights assigned to banks should be linked to their underlying strength and creditworthiness and not the country in which they are incorporated, in order to preserve the Committee's own pronounced objective of competitive neutrality and to avoid discriminatory practices unfavourable to emerging markets. For these reasons, the proposal of applying the risk weight, which is one category less favourable than that of the sovereign, to the bank, is not justified.

RBI is of the view that the risk weighting of the banks should be de-linked from that of the Sovereign in which they are incorporated.

6.5.2 The second option (viz., assigning risk weights on the basis of ratings given by external credit assessment institutions) would call for putting in place a mandatory periodical rating system and public disclosure for all the banks. While RBI recognises, in principle, the need to differentiate between a strong and a weak bank, it is concerned about the objectivity and track record of external rating agencies and the over-reaction of market participants to the public disclosure of the ratings of weak banks, which may aggravate their position further.

6.5.3 Banks are strongly regulated and supervised entities. In particular, weak banks are subjected to more rigorous on-site and off-site supervision. RBI therefore, feels that assigning risk weights against claims on banks on a scale of 20% to 150% (50% for unrated banks under the second option) is not appropriate. Further, the proposal to assign 50% risk weight against the claims on unrated banks would reward banks that would command only lower ratings on the basis of their financials. It is, however, appropriate that risk weight on weak banks needs to be increased so as to capture the enhanced risk involved in exposure to these banks.

RBI is of the view that banks should be encouraged to go in for assessment by domestic rating agencies who have greater access to the macroeconomic conditions and regulatory and supervisory framework and preferential risk weight in the range of 20% to 50%, on a graded scale, could be assigned on the basis of ratings.

6.5.4. *RBI is of the view that the preferential risk weight proposed to be assigned to short-term claims i.e., one category more favourable than the usual risk weight on the bank's claims, will seriously jeopardise the stability of international financial architecture. From the* *macroeconomic point of view, short-term claims should not be preferred, as this will lead to regulatory arbitrage through roll-overs, concentration of short-term borrowings and serious asset-liability mismatches, which could trigger systemic crisis. Thus, the proposal to have a preferential risk weighting for short-term claims is in conflict with the objective of long-term financial stability. The proposal therefore, needs to be suitably modified. RBI is, however, in agreement with the proposal that the floor risk weight on all claims on a bank should be 20%.*

RBI is of the view that the process of assigning risk weight should not be linked to banking supervisors' implementing/endorsing the Core Principles for Effective Banking Supervision. Instead, the national supervisory authority may take this into account depending upon the local institutional environment and transparency practices.

6.6 Claims on Corporates

6.6.1 RBI appreciates the Committee's proposal to differentiate the counterparties on the basis of underlying risk profile and endorses the proposal to evolve a mechanism to apply preferential risk weighting based on the credit quality of the counterparty. However, as per the proposed risk-weighting pattern, a mere downgrade from AA–(20%) to A+(100%) would lead to a five-fold increase in the capital charge, even though the diminution in credit quality or the probability of default is only marginal. Further, an unrated corporate would have advantage of an automatic 100% risk weight whereas corporates which voluntarily opt for rating and are rated at <B – would be penalised with a 150% risk weighting. This is not only anomalous but also provides an obvious incentive to those who, for fear of low rating, do not seek a rating. The differing risk-weighting pattern would also place the corporates in a disadvantageous position relative to the similarly rated sovereigns and banks.

RBI is of the view that the Committee may consider a range of risk weight baskets to better reflect the default probabilities of corporates at different rating levels.

6.6.2 The Committee has not explicitly spelt out clearly as to what sort of rating it is looking at i.e., whether it is solicited or unsolicited or those based only on public information. The unsolicited or public information ratings are generally superficial in nature. The inclusion of unsolicited rating as a basis for assigning preferential risk weighting would undermine the very basis of the new framework, as it may lead to manifold increase in public information ratings with more quantity and less quality information and depth in corporate ratings. This may also lead to the potential for trade off between competition and quality in the rating industry. Unless checked and validated effectively, banks, their customers and the rating agencies could manipulate risk weighting. Banks generally undertake short and long–term exposures and an appropriate framework could be solicited issuer or counterparty credit ratings, for better differentiating the credit quality. Further, the long-term ratings would better reflect the default probability of counterparties and would therefore, be a better determinant for assigning preferential risk weights.

6.6.3. The population of rated entities is very few in many countries and especially in emerging markets. For example, in India, out of 9640 borrowers who are enjoying fund-based working capital facilities in excess of Rs.100 million and above from the banking system as on March 31, 1999, only 300 of such borrowers have been rated by any of the rating agencies. The European Commission has provisionally estimated that the coverage by the international rating agencies was of less than 1000 corporates in Europe.[4] It may be difficult to mandate ratings for all borrowers, especially, non-corporate entities. RBI agrees with the concerns of Mr. Edgar Meister, Member of the Directorate of the Deutsche Bundesbank, expressed during his speech made in Frankfurt on 2nd Dec. 1999 that dependence on external ratings may prompt banks to exercise less care in granting credit which would be contrary to the supervisory aim that banks themselves have every interest in improving their own risk management techniques.[5] RBI also shares his concern that strong competition among the rating agencies might lead to watering down of the quality of ratings or that corporates targeting a specific rating might engage in a kind of rating shopping.

6.6.4 *RBI is of the view that while assigning risk weights to corporates, a distinction needs to be made between corporates which are well-managed and financially sound, having AAA ratings but incorporated in countries with lower sovereign ratings and low-rated, poorly managed corporates incorporated in countries with higher sovereign ratings. RBI is of the view that the risk weight assigned to a corporate should be based on its financial strength and not linked to that of its sovereign.*

RBI is therefore, of the view that risk weighting of corporates should solely be dependent upon the credit ratings and the proposal to link it with the risk weight of the sovereign of the corporate's country of incorporation needs reconsideration.

6.6.5. *RBI recommends that ratings by recognised domestic rating agencies*, *could be adopted as an acceptable standard for risk assessment of corporates having large exposure from the financial system in excess of a material limit fixed by the national supervisor. In respect of corporates enjoying aggregate credit facilities less than the material limit, banks' own internal rating-based approaches could be adopted. National supervisors should have the discretion to use the assessments of domestic credit rating agencies or the internal ratings of banks in assigning preferential risk weights.*

RBI is of the view that assigning a risk weight of 150% is not warranted and the rating scale in the range of 20% to 100% would take care of prudential capital requirement. The small borrower accounts could be

6.7 Claims on Public Sector Entities (PSEs) and Securities Firms

6.7.1. RBI feels that it is not prudent to treat all PSEs equally, as they are in no way identical or even close to the sovereign risk. There is, however, a need for differentiating strong PSEs from weak ones**.**

RBI is of the view that claims on PSEs should be treated on par with claims on corporates and risk weight could be assigned on the basis of risk rating of either domestic rating agencies or banks' own internal rating systems.

6.7.2 As regards the Securities firms, as observed by the Basel committee, there is a need for aligning the capital standards of Securities firms and banks. Till the capital adequacy standards and supervisory framework for Securities firms are brought on par with those of banks, it will not be appropriate to treat the claims on Securities firms on par with those of banks. However, as in the case of Corporates, Securities firms may be assigned preferential risk weights on the basis of credit ratings.

6.8 Loans Secured by Property

RBI is in agreement with the proposals of Basel Committee in regard to assignment of risk weights on loans secured by property.

6.9 Other Assets

As per the Committee's proposal, the other assets are uniformly assigned a risk weight of 100%. The underlying risks of some categories of other assets viz., equity, subordinated debt, are not comparable and significantly vary with the credit quality of the issuers. This anomaly could be addressed. As indicated by European Commission, the Committee may consider assigning risk weight – one notch higher than the equivalent weighting given to senior obligation.[6]

The Committee may consider assigning higher risk weights on claims, which exhibit higher risk characteristics.

6.10 Maturity of Claims

Due to the concerns attributable to concentration of short-term exposures and serious asset-liability mismatches, RBI is in agreement with the proposal of the Committee of not taking into account the maturity of claims for capital adequacy purposes.

<u>6.11 Asset Securitisation</u>

RBI agrees with the Committee's proposals to assign risk weights on the basis of external credit assessments (by domestic credit rating agencies) and convert off-balance sheet securitised receivables, to a credit equivalent at 20% and risk weighted on the basis of obligors' weighting. However, it should be ensured that in such off-balance sheet securitised receivables, banks should not develop innovative structures, which could conceal the real nature of credit risk transfer.

Further, differential risk weighting treatment between securitised assets and claims on corporates would encourage regulatory arbitrage. For instance, while the claims on corporates rated A+ to A- are assigned a risk weight of 100%, such pool of loans when securitised with very little or no credit enhancement, would be risk weighted at 50%, a whopping 50% reduction, eventhough no change in the risk profile of the claims had occurred. The issue needs reconsideration by the Basel Committee.

<u>6.12 Internal Ratings-based Approach</u>

RBI recognises the inherent attractiveness of the approach that is based on bank's own quantitative and qualitative assessment of its credit risk. However, RBI believes that an internal ratings-based approach should form the basis for setting capital charges for all banks and that the option should not be limited only to sophisticated banks. National supervisors could set minimum standards and sound practices, including key characteristics of the rating systems and process. The internal ratings-based approaches should also be subjected to validation by the national supervisors.

6.13 Credit Risk Models

RBI is in agreement with the Committee's proposal that credit risk modelling may prove to result in better internal risk management and may have the potential to be used in the supervision of banks. However, significant hurdles, principally concerning data availability and model validation still need to be cleared before these objectives are met. Conceptually, though the proposal is good, the adoption of credit risk models as an alternative for setting capital charge in emerging markets is severely constrained by data limitations and model validation.

The historical data support and modelling capabilities of banks in such countries are also not of international standards. Thus, model-based approach could be adopted only when the banks develop sufficient expertise and database to estimate the economic capital.

6.14 Credit Risk Mitigation Techniques

6.14.1 Adoption of credit risk mitigation techniques such as offsetting transactions with the same counterparty and other on-balance sheet netting requires clearly defined legal framework.

RBI is of the view that the benefit of mitigation techniques should be extended for capital adequacy purposes only if the underlying collateral is in the form of cash or high quality liquid assets, which are readily marketable and could easily be realised without the intervention of courts. RBI also feels that the benefit of on-balance sheet netting may be extended only to banks and financial institutions, which are placed under common regulatory and supervisory standards. RBI fully endorses the Committee's view that legal enforceability of netting should be backed by robust legal systems and the documentations should be robust even in stress situations. RBI also feels that the benefit of bilateral netting in respect of all inter-bank claims may be extended only to banks/FIs.

6.14.2 *RBI recognises the need for matching of the maturity of credit risk hedging instruments with the maturity of underlying assets. However, the Committee's proposal to disallow capital recognition of the risk reduction of hedges where there is a maturity mismatch appears to be stringent and instead, as suggested, the maturity mismatches should be subjected to additional capital charges in the form of simple add-ons against the uncovered risk. The add-ons may be waived if the remaining maturities of the hedges were longer than a specified period say, 2/3 years. Enforcement of any complex structures like proportional, flat tariff or sliding approaches on the degree of maturity mismatch may be difficult to be operationalised.*

6.14.3 *RBI is in agreement with the Committee's proposal for using add-on or a haircut* *approach where the underlying and hedge assets are different. However, the Committee may consider exempting banks that have effective internal systems for monitoring the asset price movements through daily revaluations and excess margin or margin calls from the prescription of additional capital.*

6.14.4 *RBI agrees with the Committee's proposal to mandate that for the credit derivatives to have a capital reducing effect on the underlying obligation, the reference and underlying assets must be issued by the same obligor and the reference asset must rank pari passu or more junior than the underlying asset and cross-default clause must apply*.

6.14.5 *RBI agrees with the Committee's proposal to acknowledge double default effect by applying a simple haircut to the risk weight, if the probabilities of default were essentially unrelated. Should the substitution approach be considered desirable, the existing practice of allowing substitution of only high quality counterparties like sovereign and banks and financial institutions, which are brought under effective regulatory and supervisory regime, should continue*.

6.15 Interest Rate Risk

RBI agrees with the Committee's proposal to develop a capital charge for interest rate risk where these risks are significantly above average (outliers). The Committee should consider evolving framework suitable to emerging markets in identifying 'outliers'.

6.16 Operational Risk

6.16.1 RBI also acknowledges the importance of risks other than credit and market risks for banks and believes that banks should devote the necessary resources to quantify the level of such risks and to incorporate them into their assessment of their overall capital adequacy. RBI, however, feels that wider discussion is required in this area. Once the banks develop adequate expertise to identify and capture operational risk, separate capital charge could be mandated.

6.16.2 *RBI is in agreement with the Committee's proposal to review the treatment of trading book positions to ensure consistency and to reduce any arbitrage opportunities. RBI also appreciates the need for differing treatment for trading book positions with moderate liquidity and providing adequate capital charge to reflect price volatility of underlying securities of Repo transactions.*

6.17 Supervisory Review Process – the Second Pillar

RBI is in agreement with the Committee's proposals that each financial institution critically assesses its capital adequacy and future capital needs in relation to risk profile and that supervisors should have a method for reviewing the internal capital adequacy assessments of individual banks and discussing internal capital targets set by the banks. RBI also agrees with the Committee that national supervisors should intervene at an early stage to prevent capital from falling below prudent levels. At the same time, the burden of estimating economic capital may not be mandated to smaller banks, which are not offering complex products and operating *predominantly in domestic / segmented markets. RBI also agrees that supervisors should have the mandate to require banks to hold capital in excess of minimum regulatory capital ratios***.**

6.18 Market Discipline – the Third Pillar

RBI is in agreement with the Committee's views that increased disclosures, enhanced transparency and market discipline are becoming an important tool of supervision. However, at the same time, national supervisory authority should also consider the ability of the market to logically interpret the available information; otherwise, there is a possibility of over reaction to insignificant events or factors, which can destabilise the system.

7.Transition Period for Emerging Markets

In view of the less developed institutional and accounting infrastructure, many emerging market economies may not be able to implement all the proposed measures, as and when they take final shape and the new framework finally replaces the 1988 Accord. Specifically, emerging markets would need certain transition period to implement proposals in respect of consolidation of accounts and assigning capital on a consolidated basis, setting benchmarks and approving the rating methodologies of domestic rating agencies, improving the technical capabilities of supervisors and financial institutions, mapping of individual ratings of banks with the regulatory risk weight baskets, assigning of explicit capital charge for interest rate risk in the banking book and other risks e.g., operational risk, estimating economic capital and introducing more disclosures on risk-based capital ratios, etc. Basel Committee may consider these constraints and explicitly provide for sufficient transition time for emerging markets in the final Framework.

8.Conclusion

8.1 The Basel Committee's initiative in addressing the rigidities of 1988 Accord is welcome. The proposed New Capital Adequacy Framework would provide the thrust in improving the financial soundness of banks. The proposal to improve the way the regulatory capital reflects the underlying risks and to recognise risk mitigation through improvements in risk management practices is in the right direction and would contribute to strengthen the international financial architecture.

8.2 RBI is also broadly in agreement with the three-Pillar approach proposed in the new Framework. However, the new Framework needs to take into account the institutional realities and the other factors specific to the emerging market economies. Particularly, the proposals in relation to assigning greater role for external credit rating agencies (para 2 of Annex 2), risk weights on sovereigns (para 6 of Annex 2), claims on banks (para 11 and 12 of Annex 2), assigning preferential risk weights on short-term claims on banks (para 12 of Annex 2), sharp changes in risk weighting on corporates (para 18 of Annex 2) and certain other procedural issues as pointed out in the comments above may be reconsidered and suitably reflected while finalising the new Framework.

8.3 With the proposed modifications as above, the new Framework will promote greater financial stability both for developed and emerging market economies.

* Consultative paper issued by the Basel Committee on Banking Supervision, Basel, June 1999 (see Annexure)

[1] A Review of Regulatory Capital Requirements for EU Credit Institutions & Investment Firms - Consultation Document released by European Commission. (Para. 37 – page 16).

[2] "Sovereign Credit Ratings", Current Issues in Economics and Finance (Federal Reserve Bank of New York), Vol.1, No.3, June 1995, PP 2-3.

[3] Working Paper on Supervisory Lessons to be drawn from the Asian Crisis, BIS (Para.2 C)

[4] A Review of Regulatory Capital Requirements for EU Credit Institutions & Investment Firms - Consultation Document released by European Commission. (Para. 34 – page 25).

[5] BIS Review No.133 dated 7.12.1999 - Page 8. *treated as 'unrated' and be assigned 100% risk weight.*

[6] A Review of Regulatory Capital Requirements for EU Credit Institutions & Investment Firms - Consultation Document released by European Commission. (Para. 42 – page 26).