

Comments of the Reserve Bank of India on the New Basel Capital Accord

Introduction

The initiatives taken by the Basel Committee in addressing the rigidities in the 1988 Capital Accord by evolving a comprehensive and risk-sensitive New Basel Capital Accord (the New Accord) are timely. The range of options for providing capital would facilitate banks with varying degrees of sophistication to adopt appropriate method with supervisory validation. Further, the emphasis laid on the role of supervisory review process and market discipline, as essential complements to minimum capital requirements would go a long way in enhancing the efficacy of supervision.

2. RBI recognises that several of the concerns expressed and recommendations made by India and other emerging markets on the first consultative document have been taken into account and addressed in the second consultative document. Particularly, the proposals to do away with the sovereign floor in assigning risk weights and subscription to IMF's Special Data Dissemination Standards (SDDS) and Core Principles for Effective Banking Supervision for preferential risk weighting, greater use of Export Credit Agencies (ECAs), additional risk weight bucket of 50% in respect of claims on corporates, simplified internal rating based approach, etc., reflect the Committee's endeavour in evolving a consensual framework which could be adapted by all countries including emerging markets.

3. In this context, the Basel Committee's concerns for the constraints which are faced by the emerging markets and greater outreach by involving non G-10 countries in the standards setting exercise would lead to greater appreciation for the New Accord. However, some of the issues in the context of emerging markets are still to be addressed. RBI feels that the complexity and sophistication of the proposals restricts its universal application in emerging markets, where the banks continue to be the major segment in financial intermediation and would be facing considerable challenges in adopting all the proposals. The New Accord would involve shift in direct supervisory focus away to the implementation issues. Further, banks and the supervisors would be required to invest large resources in upgrading their technology and human resources to meet the minimum standards. The increasing reliance on external rating agencies in the regulatory process would undermine the initiatives of banks in enhancing their risk management policies and practices and internal control systems. The minimum standards set even for the Internal Rating Based (IRB) foundation approach are complex and beyond the reach of many banks. Further, while the Basel Committee desires neither to produce a net increase nor a net decrease in minimum regulatory capital, it is felt that the current proposals are going to result in significant increase in the capital charge for banks, especially in emerging markets. The emerging markets with their low technical skills, structural rigidities and less robust legal system, etc. would face serious implementation challenges. RBI, therefore, feels that the spirit of flexibility, universal applicability and discretion to national supervisors, consistent with the macro economic conditions specific to emerging markets ought to be preserved while finalizing the New Accord.

4. RBI has examined all the aspects of the proposals contained in the New Accord and the specific comments thereon are detailed hereunder:

4.1 Scope of Application

4.1.1 RBI agrees with the Committee's view that the focus of the New Accord may be primarily on internationally active banks, which would be followed by adherence by all

significant banks after a certain period of time. The basic philosophy of the New Accord being to achieve competitive equality and financial stability and the Committee's pronouncement that the underlying principles are generally suitable to all types of banks around the globe, the New Accord, like the 1988 Accord, should be applied, generally to all banks. However, RBI shares the views of Mr. Laurence H. Meyer, Member of the Board of Governors of the Federal Reserve System that '*it is not at all obvious that the proposed standardised approach fits the needs of smaller banking organization engaged primarily in traditional banking activities... but I question whether the added implementation burdens are cost-effective for traditional banking organizations, especially since neither the current nor the proposed capital frameworks yet address what is perhaps the most critical risk factor for smaller banks – geographic and sectoral concentrations of credit risk*'¹.

4.1.2 It is, therefore, suggested that a simplified standardised approach, based on internal rating systems of banks may be evolved and applied to banks, which are **not** internationally active. Under this approach, standardised risk weights in the range of 0% to 150% on the basis of internal ratings of banks, could be assigned, subject to mapping of such ratings with the benchmark Probability of Default (PD) estimated by the supervisor on the basis of pooled data from select banks. As a precursor, however, internal rating systems of banks need to be substantially upgraded and strengthened, keeping in view the best practices and the standards prescribed by the Basel Committee for IRB approach.

4.1.3 Recognising, however, the fact that even the simplified approach is likely to be more extensive and complex than the 1988 Accord, the New Accord may be applied, **in phases**, at the discretion of national supervisors to banks on the basis of the complexity, scale of operation, etc. Each national supervisor may, however, be required to publicly announce a schedule for implementation of the New Accord and the status of implementation may be evaluated under the proposed framework for exchange of information amongst member countries.

RBI, therefore, agrees with the view that the New Accord should initially be applied to all internationally active banks. Further, a simplified standardised approach, as suggested above, may be evolved for other banks and that national supervisors should have discretion to implement the New Accord, in a phased manner.

4.1.4 As the main objective of the New Accord is to ensure competitive equality and providing a reasonable degree of consistency in application, it is necessary that all supervisors, across the world should have a common definition of internationally active and significant banks. Basel Committee may, therefore, define what constitute internationally active and significant banks.

In this regard, RBI is of the view that all banks with cross-border business exceeding 15% of their total business may be defined as internationally active banks. Significant banks may be defined as those banks with complex structures and whose market share in the total assets of the domestic banking system exceeds 1%. In the event of no consensus evolving on a uniform definition, national supervisors should have discretion to define what constitutes an internationally active and a significant bank. Each national supervisor may, however, be required to announce the criteria adopted for defining internationally active and significant

¹ Remarks by Mr. Laurence H. Meyer, Member of the Board of Governors of the US Federal Reserve System, at the Annual Washington Conference of the Institute of International Bankers, Washington D.C., 5th March, 2001

banks in its jurisdiction through the Basel Committee. The criteria, when endorsed, should be accepted by supervisors in other jurisdictions and by international agencies.

4.2 Cross-holding of Capital

RBI, while appreciating the Committee's proposal that reciprocal cross-holdings of bank capital artificially designed to inflate capital position of banks should be deducted, feels that cross-holdings of equity and other regulatory investments also need to be moderated to preserve the integrity of the financial system and minimise the adverse effect of systemic risk and contagion.

RBI is, therefore, of the view that the Basel Committee may consider prescribing a material limit (10% of the total capital) upto which cross-holdings of capital and other regulatory investments could be permitted and any excess investments above the limit would be deducted from total capital.

4.3 Claims on Sovereigns

4.3.1 RBI reiterates its earlier views that it will not be proper to link the risk weights assigned to claims on sovereigns on the basis of assessments of External Credit Assessment Institutions (ECAIs), as their credibility and past record lack empirical evidence. In the recent past, the credit rating agencies had resorted to sudden and rapid downgrading of certain countries, which experienced financial crises that exacerbated the tendency of financial institutions to risk for exit.

RBI, therefore, reiterates that the ECAIs should not be assigned the direct responsibility for risk assessment of banking book assets. This also applies to the assessments of Export Credit Agencies (ECAs) as their independence and judgment are also subject to the same limitations as those of the rating agencies.

4.3.2 The Committee's proposal that the assessments of ECAs are recognized only if they publish their risk scores and subscribe to the OECD 1999 country risk assessment methodology is appreciated. However, the OECD methodology and ECAs' country risk classifications are still confidential. Further, their insight into the local conditions and issues specific to emerging markets is also not comprehensive.

RBI, therefore, feels that such of the ECAs that disclose publicly their risk scores, rating process and procedure and subscribe to the publicly disclosed OECD methodology and qualify for use by national supervisors should only be eligible for use in assigning preferential risk weights.

4.4 Claims on Banks

4.4.1 The flexibility to provide uniform risk weight i.e. one category less favourable than that assigned to claims on sovereign to all the banks (under first option) militates the basic philosophy of aligning capital adequacy assessment more closely with the key elements of risk. The mere location may not necessarily be a good indicator of a bank's creditworthiness. This proposal provides competitive advantage to banks with weak financials by virtue of their having been incorporated in better-rated countries.

RBI, therefore, reiterates its earlier view that the risk weighting of banks should be de-linked from that of the credit rating of sovereigns in which they are incorporated. Instead, preferential risk weights should be assigned on the basis of their underlying strength and creditworthiness.

4.4.2 Banks are strongly regulated and supervised entities. In particular, weak banks and those banks, which show signs of problems, are subjected to rigorous on-site and off-site supervision and stringent prudential standards. Thus, risks inherent in inter-bank exposures are not comparable to that of the corporates. There is, therefore, a need for a modified treatment for claims on banks. The Basel Committee has provided discretion to national supervisors to assign a lower risk weight to the exposures to the sovereign of incorporation, denominated in domestic currency and funded in that currency. A similar flexibility should be provided in respect of claims on banks as well.

RBI, therefore, feels that on the lines of discretion provided in the case of claims on sovereigns, the national supervisors may be given discretion to assign lower risk weight (one category less favourable than the risk weight to claims on sovereign), subject to a floor of 20% to claims on all banks, which are denominated in domestic currency and funded in that currency.

4.4.3 The proposal to assign preferential risk weight to short-term claims may lead to regulatory arbitrage through roll-overs, concentration of short-term borrowings and serious asset-liability mismatches, which could trigger systemic crisis and contagion in the domestic inter-bank market. It would also be very difficult to monitor and control the rollovers of short-term claims, given the high volume of transactions in the inter-bank market.

RBI, therefore, feels that preferential risk weights should not be linked to the maturity of the claims.

4.5 Claims on Corporates

4.5.1 RBI appreciates the Committee's efforts in evolving a range of risk-sensitive options for assessing capital for credit risk. However, the reliance on ECAs under the standardised approach for assigning preferential risk weights may not be a better option. First, the credibility of the rating agencies is at stake and there is no system of accountability for sharp deterioration in the credit quality of rated entities immediately after assigning a rating. Secondly, their access to information, especially in the absence of transparency and good corporate governance principles is severely restricted. Whereas, banks are privy to customer information and are less exposed to customer-related informational asymmetry. Thirdly, the population of rated entities, even in the advanced countries, and especially in the emerging markets, which have exposure to the banking system, is very few in number. Fourthly, the use of external credit rating agencies in the regulatory process may act as a disincentive for the banks to improve their credit risk management systems.

4.5.2 It is appreciated that the expanded role envisioned for IRB approach provides positive incentives to banks in improving their credit risk management techniques. However, the adoption of the IRB approach, even under the foundation approach requires considerable investments in IT / human resources and rigorous supervisory oversights. Thus, most of the banks may not be able to adopt, even in advanced markets, the IRB foundation approach.

4.5.3 RBI, therefore, feels that adoption of the IRB approach, as envisaged, may be possible only for internationally active banks within the time frame and transition period proposed by the Committee. For other banks, as an alternative, it is proposed that a **simplified standardised approach** to assign preferential risk weights based on internal ratings of banks may be evolved, subject to complying with the minimum standards prescribed by the Basel Committee for IRB approach. Under this approach, standardised risk weights, instead of the continuous function of PD, Loss Given Default (LGD) and Exposure at Default (EAD), in the range of 20% to 150% could be assigned, subject to mapping of these ratings

based on the robustness of the rating systems and the benchmark PD estimated by the supervisor on the basis of pooled data from select banks.

4.5.4 This approach could be extended to a greater number of counterparties such as unrated borrowers in the small/retail sector and will encourage banks to refine their credit risk assessment and monitoring process, which would facilitate better management of their loan books. This will also avoid the use of ECAIs in the regulatory process and reduce the burden of additional cost on this count. Also, the scarce supervisory resources will be optimally utilised for validating the banks' internal rating systems rather than for approving ECAIs. This would also avoid conflict of jurisdiction over rating agencies.

RBI, therefore, proposes that while internationally active banks may be required to follow the IRB approach, a simplified standardised approach may be evolved for other banks, whereby standardised risk weights in the range of 20% to 150% could be assigned on the basis of internal ratings of banks.

4.6 Higher-risk Categories

4.6.1 The Committee's proposals to assign 150% risk weight on unsecured portion of any asset that is past due for more than 90 days, net of specific provisions, would adversely affect the capital position of banks, especially those incorporated in emerging markets. Normally, banks take some time in initiating the legal process after recognising impairment. Further, there are well-established norms for recognition of and full provision for any known loan losses. Collaterals also back such loans. Thus, the proposal to assign 150% risk weight even after recognising, in full, diminution in the value of impaired loans would lead to pre-emption of scarce capital which does not reflect the historical loan loss experiences. In India, the adoption of the proposal alone would increase the risk-weighted assets of the banking system by USD 3.2 bio, entailing a drop in the existing CRAR by 31 bps. as on March 31, 2000.

4.6.2 The 90-day norm also makes the regulatory capital extremely pro-cyclical. While during the boom period there would be low accretion to NPAs leading to lower provisioning requirements and higher capital adequacy ratio, during the recessionary phase, temporary cash flow problems accentuate the pace of accretion to NPAs and hence the need for higher provisioning requirements leading to lower capital adequacy ratio.

4.6.3 Lending by banks especially in the emerging markets is basically for productive purposes and are adequately collateralised by various types of assets. The proposal to reckon only the eligible collaterals for the secured portion of assets, which are past due for more than 90 days, is too restrictive. National supervisors should have discretion to recognise a wider range of collaterals for reckoning the secured portion of the assets.

RBI, therefore, feels that assets that are overdue over 90 days need not be placed under a separate higher-risk category.

4.7 External Credit Assessments

RBI appreciates the Committee's endeavour in addressing most of the deficiencies inherent in the first document regarding the use of ECAIs. The operative details about implementation considerations viz. mapping process, multiple assessments, issuer versus issue assessment, etc. would go a long way in addressing the supervisory concerns expressed by many regulators including RBI. However, the proposal to use unsolicited ratings in the same way as solicited ratings would undermine the efficacy of using external assessments for regulatory purposes. The unsolicited ratings are generally superficial. The use of such

ratings for assigning preferential risk weights would undermine the basic philosophy of the New Accord. It may also lead to the potential for trade off between competition and quality in the rating industry.

RBI is of the view that preferential risk weights should be assigned only on the basis of solicited ratings.

4.8 Internal Rating Based Approach

4.8.1 RBI appreciates the Basel Committee's proposal to offer a range of options of increasing sophistication for providing explicit capital charge for credit risk. RBI recognises the inherent attractiveness of the IRB foundation approach, which will result in better internal credit risk management and may have the potential to be used in the supervision of banks.

4.8.2 However, the minimum requirements stipulated even under the IRB foundation approach are difficult to be enforced, especially in the emerging markets. Most of the banks do not have robust rating systems and historical data on PDs, nor do the supervisory authorities maintain time series data for estimating LGD. The transition period of three years proposed in the New Accord may, therefore, not be adequate for building database on various parameters. It is pertinent to quote Mr. Laurence H. Meyer that '*despite the importance of evaluating a borrower's probability of default, banks have been surprisingly slow, it seems, to distinguish among acceptable credit risk levels in their pricing and in their own assessments of capital adequacy... Last fall, the Basel Committee conducted an initial survey of large internationally active banks in order to estimate the quantitative effects of the proposal on their capital requirements. The Committee was disappointed in the modest number of banks worldwide that could provide meaningful distributions of credit quality, even for their corporate portfolios*'².

RBI, therefore, suggests that a simplified standardised approach as indicated in para 4.1.2 above might be evolved and applied to banks that are not internationally active.

4.8.3 It is well recognised that the proposal to assign banking book exposures into six broad classes of exposures with different underlying credit risk characteristics - corporates, sovereigns, banks, retail, project finance and equity under IRB approach would better discriminate the likely pattern of portfolio losses. However, a common framework for definition of these loan portfolio segments, without recognising the institutional framework, value of accounts, geographical spread, etc., may pose severe implementation problems to banks in emerging markets.

RBI, therefore, feels that national supervisors may have discretion and flexibility in defining the exposure classes, viz. corporate, retail, sovereign, project finance, etc.

4.9 Operational Risk

4.9.1 In the context of increasing globalization, enhanced use of technology, product innovations and growing complexity in operations, RBI agrees, in principle, with the Committee's proposal to assign explicit capital charge for operational risk. RBI also acknowledges that the range of approaches of increasing sophistication - basic indicator, standardised and internal measurement - would set the basic framework for estimating

² Remarks by Mr. Laurence H. Meyer, Member of the Board of Governors of the US Federal Reserve System, at the Annual Washington Conference of the Institute of International Bankers, Washington D.C., 5th March, 2001

capital for operational risk. Given the sophistication and database required for standardised and internal measurement approaches, most of the banks, especially those domiciled in emerging markets would be adopting the basic indicator approach.

4.9.2 However, the current provisional estimate of around 30% of gross income, which as per Committee's estimate works out to 20% of the current capital requirement as per the 1988 Accord, is expected to impose significant burden on the capital requirement of banks. Further, it also does not reflect the risk profile of various banks, operating under various levels of sophistication, markets, etc. It is observed that the fixed percentage has been prescribed on the basis of economic capital set by only 6 international banks for operational risk. As the magnitude of operational risk depends on complexity of operations, absorption of technology, value of transactions, legal / supervisory framework, internal control systems, etc., a uniform rate may not reflect the degree of operational risk. The Committee may consider undertaking studies on operational risk with particular reference to observed rate of losses, correlation between credit and market risks and operational risk, etc.

RBI, therefore, feels that until a scientific method to measure the operational risk across countries is evolved, the Basel Committee may consider prescribing a lower capital charge of 15% of the gross income or 10% of the current capital requirement to align capital to the underlying risk profile. National supervisors may, however, be given discretion to prescribe higher capital charge towards operational risk in case of banks, which may be considered as 'outliers'.

4.10 Trading Book Issues

4.10.1 The Basel Committee has indicated that the changes made in the trading book are consistent with the changes in the banking book capital requirements under the standardised approach. However, the Committee's proposal to provide explicit capital charge on the basis of ratings is not consistent with the banking book capital requirements as discussed hereunder.

4.10.2 Under the standardised approach, discretion has been provided to assign a lower risk weight to banks' exposure to the sovereign of incorporation denominated in domestic currency and funded in that currency. A similar discretion should be provided for specific risk capital charge for trading book to avoid regulatory arbitrage.

4.10.3 Further, the graduated specific risk charge for qualifying securities has not been consistent with preferential risk weights proposed in the banking book, as these have been differentiated only on the basis of maturity rather than linking the capital charge to the rating of the instruments. Further, the uniform capital charge of 8% to other category does not reflect and compare with the risk weight of 150% or higher being proposed for claims on sovereigns, banks and corporates that are rated below B-. Unless, the capital charge or risk weights are uniform both in the trading and banking books, the New Accord may lead to banks going for regulatory arbitrage.

RBI, therefore, feels that the capital charge for specific risk in the banking and trading books should be consistent to avoid regulatory arbitrages.

4.11 Market Discipline – Third Pillar

RBI shares the Committee's view that too much information could blur the key signals to the market and agrees with the proposal to make a clear distinction between core and supplementary disclosures. Further, the proposals to mandate frequent disclosures on

information, subject to rapid time decay, would facilitate market participants in taking informed decisions.

5. Transitional Arrangements

5.1 The Committee has provided a three year transition period beginning from the date of implementation for applying full sub-consolidation. Similarly, a three-year transition period has been provided for the foundation IRB approach, during which period, the requirements could be relaxed, although supervisors would be expected to ensure that implementation of IRB approach is done by banks in a sound manner.

5.2 While RBI feels that the above transition period would be sufficient for the internationally active banks, other banks may need more transition period even for implementing the suggested simplified standardised approach.

RBI, therefore, feels that national supervisors may be given discretion to implement the New Accord, in a phased manner by banks, which are not internationally active and are engaged predominantly in traditional banking.

6. General Issues

6.1 Impact on Capital under Standardised Approach

6.1.1 Under the standardised approach, the Committee desires neither to produce a net increase nor a net decrease, on an average, in minimum regulatory capital, even after accounting for 20% explicit capital charge for operational risk. The Committee's views are apparently based on the assumption that capital discharge would be available on assigning preferential risk weights to claims on sovereigns, banks and corporates, on the basis of external assessments and recognition of more collaterals under credit risk mitigation techniques.

6.1.2 However, RBI feels that the adoption of the New Accord would definitely enhance the minimum regulatory capital, especially for banks domiciled in emerging markets on account of the following:

- (i) All claims on sovereign (OECD or non-OECD) in India are currently assigned a uniform risk weight of 0%. The discretion to assign a lower risk weight would henceforth be available to claims on sovereign (or Central Bank) of incorporation, denominated in domestic currency and funded in that currency. Other sovereigns are required to be assigned risk weight in the range of 0% to 150% on the basis of external assessments;
- (ii) Similarly, the claims on all banks are also assigned a uniform risk weight of 20%. The 20% risk weight would henceforth be converted as a **floor**. Most of the banks are also not rated and therefore would have to be assigned a risk weight of 50%;
- (iii) The population of rated corporates is very few in number and most of them would have to be risk weighted at 100%. The benefit of lower risk weight of 20% and 50% would therefore be available only to very few corporates;
- (iv) Unsecured portion of any asset which is past due over 90 days, net of specific provisions, would have to be assigned a risk weight of 150%, which proposal alone would increase the risk-weighted assets of the banking system by USD 3.2 bio, entailing a drop in the existing CRAR by 31 bps. as on March 31, 2000;
- (v) Claims on certain high-risk exposures viz. venture capital and private equity, at national discretion, are also required to be assigned a higher risk weight of 150%;
- (vi) The deduction of significant investments in commercial entities; and
- (vii) Explicit capital charge, constituting 20% of the current capital requirement for operational risk.

6.1.3 The benefit of credit risk mitigation techniques also may not be available as most of the banks in emerging markets are not in a position to comply with the preconditions stipulated by the Basel Committee.

Thus, unless suitably modified, the adoption of the New Accord in its present format would result in significant increase in the capital charge for banks, especially in emerging markets.

6.2 Areas of Further Consultation

Some of the proposals contained in the New Accord warrant further consultation and the Committee itself has indicated that the work was in progress in specific areas viz. IRB approach, risk mitigation techniques, capital for operational risk, etc. As the objective of the New Accord is to evolve a consensual framework that could be adopted uniformly by all countries including emerging markets, the Committee may hold further consultations on these areas.

7. Conclusion

7.1 RBI appreciates the committee's efforts in evolving the New Accord containing proposals that are comprehensive in coverage. When implemented, these would go a long way in making the capital allocation more risk-sensitive and use of supervisory oversight with market discipline would reinforce the supervisory framework and ensure financial stability. However, the complexity and sophistication of the proposals restricts its universal application in emerging markets, where the banks continue to be the major segment in financial intermediation and would be facing considerable challenges in adopting all the proposals. Like the 1988 Capital Accord, the New Accord should also preserve the spirit of simplicity and flexibility to ensure universal applicability including emerging markets.

7.2 The New Accord would involve shift in direct supervisory focus away to the implementation issues. Further, banks and the supervisors would be required to invest large resources in upgrading their technology and human resources to meet the minimum standards. The increasing reliance on external rating agencies in the regulatory process would undermine the initiatives of banks in enhancing their risk management policies and practices and internal control systems. The minimum standards set even for the IRB foundation approach are complex and beyond the reach of many banks.

7.3 It is, therefore, essential that the Basel Committee should evolve a simplified standardised approach, which could be adopted uniformly by all banks that are **not** internationally active. Further, the transitional arrangements proposed in the New Accord may not be sufficient for these banks. National supervisors may, therefore, be given discretion to decide on the timeframe for implementing the Accord and applying it to various banks in their jurisdiction depending upon the scale and complexity of their operations.