UNANSWERED QUESTIONS AND STUMBLING BLOCKS IN IMPLEMENTATION OF THE NEW BASLE CAPITAL ACCORD

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When in 1999 the first consultation document on the proposed New Basle Capital Accord (NBCA) was published, the priority of issues was completely different as today. This is quite understandable. Most attention was paid to technical developments and innovations, while substantially less was paid to issues of "the fine print", of which only mention was made or their significance left to come to light only in the process of implementation. These problems included primarily the cooperation of the home and host regulator in approval and validation of the use of advanced approaches in measuring credit and operational risk and the issue of data for determining their basic characteristics.

One of the fundamental objectives of the NBCA in the field of credit risk was to provide a substantially more flexible manner of measuring it, with an emphasis on using a bank's internal models, naturally, while fulfilling a number of qualitative and quantitative requirements. This objective was based not only on the stated shortcomings of the original accord, but also on the level of technological development attained in large and global banks. After all, in the preamble of the existing as well as new accord it is unequivocally stated that it is compulsory for all internationally active banks of the G-10 countries. For these banks it is a natural prerequisite to have internal processes developed, enabling them to measure and manage all significant risks undertaken.

In order to enable more sophisticated methods to be used also for regulatory purposes, for example in determining the level of risk undertaken, and subsequently the regulatory capital required, a financial institution must be authorised to do so by the respective regulator. We will now turn to the following questions. On the one hand it is in the interest of the efficient control of the risk profile of individual financial sectors that they develop and in particular use in practice modern risk measurement methods. On the other hand, however, each state places upon its financial regulatory bodies, as one of their primary roles, the task of controlling an acceptable degree of risk undertaken by financial institutions, by means of its measurement and subsequently a respective capital requirement. It is not simply the legal means for the fulfilment of this task that is prescribed to them, but also their respective statutory responsibility. Let's have a look in the light of this role and responsibility at the principle of the home/host country regulator[1] applicable in the EU.

This principle is not new. The Basle Concordat[2], back in 1983, stipulated the principles for the cooperation of regulators and the allocation of their tasks. In the accompanying document of the Basle Committee for Banking Supervision (hereinafter BCBS)[3] it is explicitly stated that: "… consolidated supervision by the home regulator may not substitute corresponding supervision over those aspects of operations of the foreign components of a bank that are considered the responsibility of a host regulator." In distributing the responsibility between both regulators the type of institution abroad is decisive. Where it is a branch of a foreign bank, then capital adequacy is supervised by the home regulator and the monitoring of the branch's financial health is left to the host regulator. Liquidity is supervised by the host regulator, likewise the FX position. In the case of subsidiaries the host regulator's task is to supervise the three aforementioned fields on a solo basis. The home regulator remains responsible for performing supervision on a consolidated basis.

Mutual confidence, supported by the bilateral flow of corresponding information is of fundamental significance for the efficient functioning of the principles of the

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[1] The principle of the home/host country regulator (hereinafter H/HR) is known for example from the Banking Directive 2000/12/EU, defining supervision on a consolidated basis and prescribing that in the case of branches of a foreign bank supervision is performed by the home regulator, i.e. the regulator from the country where the parent company is seated. This applies also in the case of subsidiary companies in a different country where the host regulator supervises the subsidiary only on a solo basis. The mutual relationship between the home and host regulator is not de facto governed by this Directive and, for example, the type and volume of information exchanged is left up to the mutual agreement of the regulators.

[2] The Basle Concordat: Principles for the Supervision of Banks' Foreign Establishments (May 1983), www.bis.org

[3] Authorisation procedures for banks' foreign establishments (March 1983) www.bis.org

consolidated performance of supervision and the principle of the home/host regulator. Here, it is worthwhile recognising that the perceptions of both regulators need not be identical. What is important is the understanding of the term "significance". What, in the framework of a whole group is insignificant (or immaterial) need not at all be so at the level of the host regulator, in particular where the volume of the two corresponding banking sectors are radically different. While the majority of financial institutions operated prevailingly in their home market and foreign components played a secondary role, the application of the home/host regulator principle was relatively simple. The activities of foreign institutions formed only a supplement to the main activity of home institutions and their importance was not decisive. The change could be dramatic when the prevailing part or the whole home banking sector is composed of subsidiaries of foreign institutions, or directly branches of foreign banks. Through the literal application of the H/HR principle the whole body of the direct performance of supervision is shifted on to regulatory authorities in the country where the institution is seated and the host regulator is left merely with the role of "observer", moreover one with limited possibilities as to information concerning the group's activities. The situation is even more complicated where the prevailing part of the local banking sector is formed by branches. That this is not mere theory is currently demonstrated by the case of the financial group Nordea[4]. This group through changing subsidiaries into branches de facto should have created a large transfrontier banking sector, which was subject, from the aspect of supervision, to regulation in the country of its head office. It was shown that the H/HR principle in its hitherto general formulation is insufficient for this case. It was necessary for the countries of the affected host and home regulators to conclude substantially more specific agreements, detailing more specifically their responsibilities, including the content of the information exchange. The whole structure will become more complicated in 2005 if Nordea gains the status of a "European company"[5], enabling it to change its head office according to its own will. Neither the current structure nor regulatory principles, including H/HR principle, are prepared for this form of business. Unless the position and information between the home and host regulator are put on a level footing, the question remains as to what the quality of supervision will be. We can ask ourselves the legitimate question of whether we are heading towards a "flying" group of regulators for a given group, which will supervise over this structure in a "supra-national" sense. And immediately there follows the question, in integrating the performance of supervision by means of the H/HR and the consolidated of supervision principle, how will the host regulator come to terms with its legal responsibility at the local level? What are the tools for performing supervision by the host regulator, if the whole of its banking sector is composed of branches of foreign banks, which, moreover, are insignificant from the aspect of the volume of operations and size in the framework of the group?

We began with the problem of approving more advanced methods of measuring individual risks. If we apply the H/HR principle in this field, then the task of the host regulator for approving more advanced approaches may be quite limited, especially if a part of a financial group falling within its competence is immaterial from the aspect of the group's size. BCBS published in August 2003 the High level principles by which cross-border relations between regulators in approving processes in implementing the NBCA are to be governed. The main idea is to reduce the burden of demands made upon financial institutions by regulators, removing duplication and adapting the performance of supervision to the organisational structure of financial groups. Though this principle may be most correct it can also have several stumbling blocks, since if for determining the risk profile of a small component of a large financial group we use characteristics that are applicable for the group as a whole, then we don't necessarily have to get a realistic picture of the risk actually undertaken by this component. A prerequisite for compatibility of measuring risk at the consolidated as well as solo level contains the very strong implicit condition of an absolute homogeneity of characteristics on group-wide level, in particular from the qualitative aspect. It is sufficient here to mention the infamous case of Barings Bank in order to recognise that this need not necessarily be true[6] and what consequences the non-fulfilment of this condition can have.

Data are a key component of measuring the risk profile of a financial institution. We will now turn to the problems which are connected with the data's acquisition and interpretation. An essential prerequisite for the rea-

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[4] Nordea is a banking and insurance group, established in 2000 through the merger of banking institutions in four northern countries (Merita – Finland, Nordbanken – Sweden, Unidanmark – Denmark, and Christiana Bank – Norway). This financial group should change the legal status of its subsidiary banking companies to branches of a foreign bank in 2005. By doing so large parts of the local banking sectors would have been de facto exempted from the competence of the local regulator.

[5] The status of a European Company means that the company is a single legal entity in the framework of the EU.

[6] The internal control of the bank stated in its report several shortcomings in the managerial and control procedures in several Asian components of the group, which enabled Nick Leason to take a loss position and perform fraudulent operations leading to the collapse of the whole banking group.

listic measurement of individual risks are, inter alia, for example, existing historical data on losses or the recovery rate of defaulted claims, whether in relation to a counterparty or to a used product and exposure. This prerequisite is natural in particular for the more developed parts of a banking group, but it becomes problematic, when we want to expand the principle of using internal measurement to all banks, or to more backward parts of a banking group. If this prerequisite is reflected for example in the European Union Directives, their implementation will become substantially more problematic. The reason is very simple. Implementation of the Directive is an obligation of all Member States and in this case it applies for all banks, regardless of the degree of their sophistication.

Let us look at the nature of the data required for internal models of credit risk measurement. To certain extent, however, what follows applies also for the measurement of operating risk. Data required for any risk measurement model contains in its essence a certain nature of loss. This, naturally, depends on many factors: on the economic cycle, the economic strength of the debtor, the processes by which the bank deals with its debtors and on its internal culture (or corporate governance), the legal characteristics of the environment in which the bank operates, etc. When we think of this whole set, we find that all these factors can be divided into two main groups.

The first group represents quantitative factors characterising the ability of a debtor to settle a bank's claim. These factors are objective and can be quantified rationally.

However, the second group is made up of qualitative factors, characterising the willingness of a debtor to settle a claim and need not be in any way connected with the debtor's ability to repay the debt. This group is composed of subjective factors and can be directly quantified only with great difficulty, if at all.

In order to be specific, let us consider for example the measurement of credit risk and the PD[7] factor (probability of default), the probability that the counterparty, the debtor, will not pay the receivable. The situation is clear, where a debtor cannot pay due to bankruptcy. The situation is more delicate when the debtor is choosing between which of several of his creditors it will pay first. And it is here that the quality of the internal procedure of the bank comes into play, the way how the bank monitors its debtors. It is understandable that a more prudent bank will have a lower PD value, simply due to the fact that it closes its exposure before a situation arises that would increase the PD value. The situation is likewise in measuring the degree of the rate of recovery of unpaid receivables, which is characterised by the so-called loss given default (LGD[8]). Similarly, there is reflected here the internal policy and quality of the process of risk management in securing receivables by means of collateral or guarantees.

Let us then now answer the question from the introduction to this article: Is it possible to share data (on credit risk relating to one institution) between financial institutions? And we will expand it to cover a banking group: Is it possible to share data within a banking group (data on credit risk relating to one part of a financial institution)? The answer may be inferred from the preceding considerations. "Yes, but…". The meaning of the word here "but" is simple. Data can be shared, if the quality of risk management processes and risk culture is the same in all institutions, or parts. This is the alpha and omega of a positive answer to the question put, since if institutions are from the aspect stated above heterogeneous, then for a lower quality institution the use of quantitative indicators on the basis of shared data leads to an underestimation of credit risk. In contrast, a better managed institution, using quantitative characteristics on the basis of data "infected" by a lower quality of risk management would thereby overestimate credit risk undertaken. For banking sector regulators the use of such "infected" data has one adverse consequence, namely systemic risk, ensuing from inappropriate credit risk measurement, present in the regulated banking sector.

Let us look also at the example of a banking group. Here, at first glance, it would seem that the problems described above cannot occur. Let us consider the following case. According to the draft wording of the NBCA as well as the new EU directive on capital adequacy, a bank may in its consolidated calculation of credit risk exclude, using the IRB approach, immaterial exposures, or parts of the banking group. Given this condition of significance the calculation of the degree of the consolidated credit risk will certainly be in order. What, however, will happen if quantitative parameters are used for determining the level of credit risk in the excluded part of the group? Naturally, the number produced need not at all reflect the size of credit risk undertaken. Furthermore, if, for example, it is a subsidiary bank, which in the framework of the local banking system is no longer significant, then the acceptance of such a manner of measurement by the host regulator can lead to a significant underestimation of risk, indeed in the end to a systemic failure.

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[7] The probability of default is the number of cases of default for a given type of counterparty over a given period.

[8] Loss given default is the loss from a given exposure which the institution suffers in the case of a counterparty's default, where all guarantees and collateral available for this exposure at the given moment are utilised.

A second possibility concerns the use of data, and its sharing within a holding company. In the case of large banking groups with an insufficiently consolidated risk culture, such sharing of data is naturally inadmissible. It would lead to an absolutely incorrect evaluation of individual parts of the group from the perspective of the risk measured. This would apply also in the case where for all parts of a group the minimum requirements for the qualitative aspect of risk management procedures, formulated in the draft NBCA, were to be individually fulfilled. The reason for this is precisely the above mentioned subjective aspect of data on losses. This is only partially influenced by the manner of risk management. It doesn't matter whether risk management is strongly centralised or regional, or even locally decentralised. A good process and procedures of risk management are simply an essential prerequisite for enabling data on losses to be shared. Corporate governance and its homogeneity are decisive. Unless a holding company achieves the state that the risk connected with a given debtor and exposure to it, perception, control and management of it and any possible resulting loss are independent of the place in the holding company where the risk is localised, then it is not possible to use data at the level of the holding company also for risk measurement in its components.